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INTERNATIONAL TRADE ADMINISTRATION
DEPARTMENT OF COMMERCE
WASHINGTON, D.C. 20230

Case No. A-821-816
Inquiry Into the Status of the Russian Federation as a Non-Market Economy Country Under the Antidumping and Countervailing Duty Laws

INQUIRY INTO THE STATUS OF THE RUSSIAN FEDERATION AS A NON-MARKET ECONOMY UNDER THE ANTIDUMPING AND COUNTERVAILING DUTY LAWS

COMMENTS OF BETHLEHEM STEEL CORPORATION; LTV STEEL COMPANY, INC.; NATIONAL STEEL CORP.; AND UNITED STATES STEEL LLC

SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP
1440 New York Avenue, N.W.
Washington, D.C. 20005-2111
(202) 371-7000

DEWEY BALLANTINE LLP
1775 Pennsylvania Avenue, N.W.
Washington, D.C. 20006-4605
(202) 862-1000

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Russia's nonmarket economy status should not be negotiated away. Press reports indicate that the U.S. government may grant Russia "market economy" status for purposes of the U.S. trade laws as part of some broader U.S.-Russia rapprochement. However, Congress established specific criteria for determining whether a subject country should be considered a "nonmarket economy" for purposes of the Antidumping and Countervailing Duty Laws, with an eye toward preserving the competitiveness of U.S. industries. These criteria relate solely to aspects of the *economy* of the subject country – not the extent to which the country cooperates with the U.S. in the diplomatic and military realm. The Department should not declare Russia to be a "market economy" as part of a geopolitical bargain when the country does not come close to satisfying the criteria established by the Congress and by the Department itself in its prior decisions. Application of the requisite criteria make it clear Russia is not a market economy.

Criterion 1: The extent to which the currency of the foreign country is convertible into the currencies of other countries. In Russia, numerous regulatory requirements limit the free convertibility of the ruble. Legislation which would liberalize these restrictions has been postponed for the foreseeable future.

Criterion 2: The extent to which wage rates in the foreign country are determined by free bargaining between labor and management. In Russia, trade unions that purport to represent workers are weak or corrupt, strikes are widely considered illegal and are often suppressed when they do occur, and the government rarely enforces laws which purport to guarantee labor rights. Russian workers are severely restricted in their mobility by a Soviet-era registration system (propiska), are often "paid" in barter, and are commonly subject to arbitrary reprisals by their employers if they seek to improve compensation or working conditions.

Criterion 3: The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country. Russian law severely inhibits inward foreign direct investment, a problem which is exacerbated by extremely high tax rates, inconsistent regulation, and the failure to enforce existing laws to protect investors' rights. Reflecting these problems, Russia receives less than $14 per capita in FDI, compared with $436 for the Czech Republic and $277 for Slovakia.

Criterion 4: The extent of government ownership or control of the means of production. The only privatization occurring in Russia since the breakup of the Soviet Union has taken place in peripheral sectors of the country's highly concentrated economy, leaving government ownership and control largely intact in Russia's core industries. In such core sectors, to a considerable extent, "privatization" has involved a mere transfer of ownership from one government entity to another, or has culminated in "renationalization" as ownership has passed from private hands back into those of a federal, regional or local government entity. The Russian government's privatization program has been at a near standstill since the onset of the Russian financial crisis in 1998.

Criterion 5: The extent of government control over the allocation of resources and over the price and output decisions of enterprises. Russian federal, regional and local governments regulate many prices directly through price controls. In addition, the federal government's antimonopoly authority has adopted the practice of setting prices itself through negotiation with the subject enterprises, resulting in *de facto* government regulation of hundreds, and perhaps thousands, of new prices each year. Finally, government-owned enterprises in large, key sectors of the Russian economy frequently set prices or collect payments based on policy objectives as opposed to profit-maximization objectives.

Criterion 6: Such other factors as the administering authority considers appropriate. In addition to the five specific criteria set forth in the NME statute for assessing whether a subject country has become a market economy, Congress directs the Department to consider "such other factors" that it "considers appropriate." The Department has considered a variety of "such other factors" in its recent determinations with respect to the transition of Slovakia, the Czech Republic, and Latvia to market economy status. An application of these factors to Russia simply underscores how sharply differentiated its situation is from the countries which have been found by the Department to have successfully made the transition.

The judicial system, political freedoms and the rule of law are severely underdeveloped. A weak judicial system, the government's frequent disregard for constitutional and legal norms, and widespread corruption have combined to produce a pervasive failure of the rule of law and respect for property rights in Russia. A substantial proportion of all economic activity in Russia is conducted by organized criminal groups. To date, President Putin's reform efforts have made little progress.

The Russian banking system is unsound and subject to manipulation. Russia's banking system is financially unsound and does not play a significant role in intermediation between savings and investment in the Russian economy. The Central Bank of Russia, heavily staffed with Soviet-era holdovers, has served as a source of preferential loans for favored industries; the bank has been racked with scandals and its bungling is blamed for some of the principal macroeconomic disasters that have engulfed the Russian economy since the Soviet breakup. In general, Russian banks are undercapitalized, often owned by oligarchs and enterprises which use them as their own private sources of funds, and are frequently involved in money-laundering and other criminal activities.

Russia lacks a well-functioning system of bankruptcy. Russia's bankruptcy regime does not provide a system of orderly and rational market exit for failed firms. The bankruptcy process has deteriorated into an instrument that enables local governments and criminal groups to control, exploit, and in some cases plunder insolvent enterprises, many of which would have been liquidated long ago in a rational system.

Russia lacks an efficient, equitable, and transparent system of taxation. Russia's tax system is arbitrary, nontransparent, and unevenly administered. Distortions in the tax system are a principal factor contributing to the proliferation of barter in the Russian economy and the explosive growth of the "underground" economy. Reform efforts are unlikely to alter this dynamic even if currently-pending reform legislation is enacted.

Russia is not an actual or imminent member in multilateral economic organizations such as the WTO, the OECD and the EU. Russia is unlikely to become a member, or assume the obligations and commitment of, multilateral organizations like the WTO, the OECD, and the European Union. Criticism of Russia's economic system by all three organizations underscores the extent to which Russia fails to meet their minimum standards for membership or closer affiliation.

The Russian economy is poorly integrated with the multilateral trading system, reflecting import barriers, chaotic marketing of exports, and much of Russia's foreign trade and customs administration is controlled by organized crime. Russia's economy is not integrated with the world trading system and in fact has exercised severely destabilizing effects on that system. The Russian domestic market is protected by a broad array of import restrictions, while disorderly Russian exports have had chaotic effects in world markets since 1991. Much of Russia's foreign trade, as well as a considerable part of the administration of the Russian customs service, is controlled or influenced by organized criminal groups.

Conclusion. Congress enacted the nonmarket economy provisions in the U.S. trade laws because of the difficulties inherent in determining factors such as "price," "cost" and "subsidies" in an economic milieu characterized by pervasive government intervention and control. Declaring Russia a "market economy" prematurely will make it very difficult for the Department to administer these laws in a fair and economically rational manner.

COMMENTS OF BETHLEHEM STEEL CORPORATION; LTV STEEL COMPANY, INC.; NATIONAL STEEL CORP.; AND UNITED STATES STEEL LLC

These comments are submitted on behalf of Bethlehem Steel Corporation; LTV Steel Company, Inc.; National Steel Corporation; and United States Steel LLC, in response to the Department's Notice of Initiation and Request for Comments published October 26, 2001.[1] The American steel industry opposes any change in the status of the Russian Federation as a non-market economy ("NME") for purposes of the U.S. antidumping ("AD") and countervailing duty ("CVD") laws. As the Department itself concluded after an exhaustive survey completed in 2000, *Report to the President on Global Steel Trade*, distortions within the Russian economy—factors which make Russia an NME—led directly to the export practices which have devastated the U.S. producers of steel products:

> *The Russian steel industry has long operated in a surreal economic environment in which cash was not necessary, inputs were cheaply provided, taxes and supplier bills went unpaid and few companies were closed due to bankruptcy... The industry's relationship with the government, its way of doing business, its current competitive position, and the measures which it has taken to adjust to the new system are still very much reflective of its past . . . .The lack of normal business considerations at the investment, production, and selling stages in the Russian steel industry led to volatility in the global steel market and damage to the steel industry and steel workers in other countries, including the United States.*[2]

It was precisely because of concern over the potentially disruptive effects of non-market economies on U.S. companies and workers that Congress enacted rules for addressing such countries under the U.S. trade laws, including (in 1988) specific criteria for determining the existence of a non-market economy.[3] The Department of Commerce applied these criteria to the Russian economy in 1995 when it rejected a request by Russian respondents to revoke the country's NME status. The Department stated:

> *We cannot conclude,... based on the information in this record that Russia should be treated as a market economy for purposes of the antidumping duty law. The Russian economy, having emerged from a centrally-planned system, is in a state of transition. Many of the state controls have been abandoned, but that does not mean that functioning markets have replaced controls. Because the evidence does not demonstrate that prices and costs in Russia adequately reflect market*

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1 *Inquiry Into the Status of the Russian Federation as a Non-Market Economy*, 66 Fed. Reg. 54,197 (Oct. 26, 2001) (Notice of Initiation).

2 *Report to the President on Global Steel Trade*, U.S. Department of Commerce (July 2000) at 40, 64. Exh. 1.

3 19 U.S.C. § 1677(19)(B) (1995).

considerations, we cannot at this time alter Russia's designation as a nonmarket economy.[4]

There is no credible basis for a finding that Russia has subsequently become a "market economy" under the criteria established by the statute and refined by Departmental precedent. Indeed, Russian observers themselves – many of whom are cited in this document – offer the most scathing critiques of the failure of a market economy to develop in Russia. As a Moscow journal observed in March 2001:

> *I will not surprise the owners of the means of production present with the claim that there is no private ownership of the means of production in Russia.... {L}aws are replaced by personal relations. Private property is turned into a system of vassal rights tying the owner of an enterprise, the governor, the president's representative, the head of the tax police, the head of the FSB {Federal Security Service} and so on .... The Russian process of unfriendly takeovers is radically different from a market-based one. In a market economy, the unfriendly invader pays more for the company than in a friendly absorption. In the Russian economy, he does not pay anything, not counting paying for the upkeep of various military formations – courts of arbitration and OMON (Special-Purpose Police Department} officers – and using up munitions. That is economic war. I repeat again: no Russian company is protected by any laws. It is protected by an awareness that if you have a go at someone who has bigger claws and teeth, you will get it in the neck. {The means of waging economic war} are diverse. If you are friendly with local power engineering companies, you can organize electricity blackouts for factories; if you are friendly with Aksenenko, you can suffocate it with a railroad blockade; or you can set the tax police onto it with the aim of frightening it and gathering free financial intelligence as Deripaska did with GAZ {Gorkiy Automobile Plant}.... {T}he Russian economy is a military economy. In a situation where it is possible to seize something for free, seizure becomes the most economically profitable means of augmenting assets.*[5]

While it may be argued that such colorful popular commentary unfairly overstates the extent of the distortions in Russia's economy, recent analyses of that economy by the International Monetary Fund ("IMF"), the Organization for Economic Development & Cooperation ("OECD"), the World Bank, and by the Department of Commerce underscore Russia's grave shortcomings in areas critical to the functioning of a market economy – protection of property rights, respect for the rule of law, a legal and regulatory regime that is not systematically arbitrary and capricious, protection of worker rights, and private ownership of the means of production.

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4 Notice of Pure Magnesium and Alloy Magnesium from the Russian Federation, 60 Fed. Reg. at 16,440, 16,443 (Mar. 30, 1995) ("*1995 Russian NME Review*") (emphasis added).

5 "Russian 'Industrial Feudalism' Described," *Moscow Novaya Gazeta* in Russian (Mar. 26, 2001) *translated in* FBIS (Apr. 4, 2001). Exh. 2.

According to some reports, Russia's NME status is being reconsidered now as part of a larger U.S.-Russia understanding with respect to cooperation in the war on terrorism. But nothing in the NME statute, or the U.S. AD and CVD laws, suggests that Congress intended the revocation NME status as a measure which could be exchanged for concessions in areas outside the economic realm.

I. Russia's Nonmarket Economy Status Should not be Negotiated Away.

Summary of comments. Congress established specific criteria for determining whether a subject country should be considered a "nonmarket economy" for purposes of the AD and CVD laws, with an eye toward preserving the competitiveness of U.S. industries. These criteria, which codified prior guidelines developed over time by the Department of Commerce, relate solely to aspects of the *economy* of the subject country – not the extent to which the country cooperates with the U.S. in the diplomatic and military realm. Declaring Russia a "market economy" as part of a geopolitical bargain when the country does not come close to satisfying the statutory criteria would contravene the intent of Congress and render the statutory NME criteria meaningless.

A. Press accounts suggest Russia may quickly be declared a "market economy" as a result of a U.S.-Russia quid pro quo having nothing to do with the actual state of Russia's economy.

Press accounts of U.S.–Russia trade talks held in September and October 2001 suggest that a quid pro quo has been reached pursuant to which Russian support for the U.S. war on terrorism will be rewarded, in part, by a speedy U.S. determination that Russia has successfully made the transition to a market economy for purposes of the application of U.S. AD and CVD laws. Such a tradeoff, were it to occur, would be inappropriate under U.S. law.

In October 2001, following talks in Moscow with Russian trade officials, U.S. Secretary of Commerce Donald Evans reportedly said that Russia could be given market economy status "within a year."[6] Similar comments were made by U.S. Trade Representative Robert Zoellick in September 2001 following talks with Russian Prime Minister Mikhail Kasyanai, who reportedly "confirmed the readiness of the American side to in the near future positively consider the question of granting Russia the status of a country with a market economy."[7] An article in the Russian journal *Kommersant* reported in October that:

> *U.S. trade negotiator Robert Zoellick met with Economic Development Minister German Gref in Moscow yesterday and officially announced that the U.S. Commerce Department had begun considering Russia's request that it be granted the status of a country with a market economy. This is how George Bush is repaying Russia for its support of the U.S. war against terrorism.*[8]

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6 "Russia Could Get Market Economy Status Within a Year -- U.S. Official," *BBC Worldwide Monitoring* (Oct. 17, 2001).

7 "Russian PM, U.S. Trade Official Discuss Russia's Progress," *Moscow Interfax* (Sept. 29, 2001).

8 Pyotr Netreba and Kanstantin Smirnov, "U.S. Paying for Support," *Kommersant* in Russian (Sept. 29, 2001) *translated in The Current Digest of the Post-Soviet Press* (Oct. 24, 2001) (emphasis added). Exh. 3.

One sarcastic Russian observer analogized the abrupt U.S. move toward concessions on the market economy issue to a hasty and ill-considered marriage recalled from an episode in Russian literature:

> *"Even old women make mistakes," Polish beauty Inga Zayonts said the day after her wedding to Kolya Ostenbaken {an allusion to characters in a Russian novel}. But before it happens, we must make use of this mysterious impulse of the pragmatic U.S. heart to at least get our economy recognized as being a market economy. We will sort out how market based it actually is after the wedding.*[9]

B. Congress did not intend the conferral of "market economy" status to be a bargaining chip in international negotiations.

The trade-off which is reportedly being contemplated is inconsistent with Congressional intent (as well as unnecessary to secure Russian cooperation in the war on terrorism).[10] Congress clearly intended a purely economic test of whether a country's economy was based on a functioning market, as the NME review statute states that a "nonmarket economy country" means,

> *any foreign country that Commerce determines does not operate on market principles of cost or pricing structures, so that sales in the country do not reflect the fair value of the goods.*[11]

Congress established criteria to be considered by the Department of Commerce in determining whether a country's economy does or does not operate on market economy principles.[12] They are as follows:

(i) the extent to which the currency of the foreign country is convertible into the currency of other countries,

(ii) the extent to which wage rates in the foreign country are determined by free bargaining between labor and management,

(iii) the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country,

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9 Olga Romanova, "Movement is All – the End Goal is Naught," *Moscow Vestiru WWW* (Nov. 13, 2001).

10 If President Putin's public statements are to be believed, a finding by the Department that Russia is a market economy is not necessary to ensure Russian support for a global effort against terrorism because that effort is in the interest of Russia as well as the United States. President Putin said in a recent interview with Barbara Walters that "he did not expect any reward for Russia's support for the U.S.-led war on terrorism, because it was in the best interests of both countries to fight their 'common enemy.'" (emphasis added). "Interview with Russian President Putin," ABCNEWS.com (Nov. 7, 2001), available at <http:///dailynews.yahoo.com/htx/abc/20011107/wl/walters_putin_011107_1.html.>.

11 *Omnibus Trade and Competitiveness Act of 1988: Conference Report*, Pub. L. No. 100-418, v. 5, 591 (April 20, 1988) (emphasis added).

12 19 U.S.C. § 1677(18)(B) (1995).

(iv) the extent of government ownership or control of the means of production,

(v) the extent of government control over the allocation of resources and over the price and output decisions of enterprises, and

(vi) such other factors as the administering authority considers appropriate.[13]

All of the above criteria relate to various aspects of the *economy* of the country in question, or political and legal factors with a direct bearing on the economy – not the extent to which the country may cooperate with the U.S. in the diplomatic, military and international political realm. There is no suggestion in the statute or in its legislative history that a determination that a country is a market economy can be made in exchange for concessions by that country in areas unrelated to trade, such as here, for example, assistance in waging war in third countries. Indeed, one of the principle reasons administration of the AD and CVD laws was transferred to the Department in 1979 was to depoliticize their application and ensure that decisions were made on substantive evidentiary grounds, rather than as a result of political and diplomatic exchanges.

The NME statute does provide that in making an NME determination, the Department can consider "such other factors as the administering authority considers appropriate," but it is a rule of statutory construction that such general catchall provisions are defined by reference to the specific factors which precede them.[14] Because the five factors preceding the catchall clause all relate to economic matters or governmental and institutional factors with a direct bearing on the economy, the "other factors" considered by the Department should be limited to such other aspects of the Russian economy and/or Russian institutional factors as relate to the economy.

The statutory test of nonmarket economy status, added to the AD law in 1988, was designed to guide the Department in an assessment of the actual economic condition of a country at issue.[15] The legislative history of the statute indicates that the test added in 1988 was intended to address domestic trade deficits, exchange rate stability and "enhance the competitiveness of

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13 *Id.*

14 *Id.* at (vi).

15 The Department itself played a major role in the evolution of the current narrow, economic-based statutory NME criteria. These criteria codified the Department's own prior practice, specifically, the analysis utilized in two cases decided by the Department immediately prior to the enactment of the six-part test involving NME countries. In *Petroleum Wax Candles from the People's Republic of China*, the following factors were considered: 1) degree of government ownership of production; 2) degree of centralized government control over resource allocation; 3) degree of centralized government control over output; 4) relative convertibility of their currency; 5) degree of government control over trade. When making this determination, Commerce focused on the operation of these factors in the industry in question, the candle sector. Additionally, the Department considered the state of the Chinese economy generally with reference to the following factors: 1) insulation of producers from market factors; 2) the requirement of licenses for all imports; 3) existence of foreign exchange and import/export controls. These cases, especially the China case, provided the predicate of the current NME statute. *See Truck Trailer Axles from Hungary*, 46 Fed. Reg. 46,152 (Sept. 17, 1981) (Preliminary Determination of Sales at Less Than Fair Value); *Petroleum Wax Candles from the People's Republic of China*, 51 Fed. Reg. 6016 (Feb. 19, 1986) (Preliminary Determination of Sales at Less Than Fair Value), 51 Fed. Reg. 25085 (July 10, 1986) (Final Determination of Sales at Less Than Fair Value) ("*Petroleum Wax Candles from China*").

American industry" – in other words, economic concerns affecting the interests and well-being of U.S. producers and workers.[16] The drafters defined the phrase "nonmarket economy" in narrow economic terms:

> *any foreign country that Commerce determines does not operate on market principles of cost or pricing structures, so that sales in the country do not reflect the fair value of the goods.*[17]

This narrow focus on economic factors and institutional factors directly related to the economy has been consistently applied by the Department in all NME reviews to date. As stated by the Department stated in its 1995 NME status review of Russia, "{r}egarding the revocation of NME status, the Department's analysis centers around a government's role in *economic activity*."[18]

16 Although earlier versions of the statute referred to nonmarket economies in the context of the antidumping laws, until 1988 there were no provisions for analyzing whether a country was or was not a market economy.

17 *Omnibus Trade and Competitiveness Act of 1988: Conference Report*, Pub. L. No. 100-418, v. 5, 591 (Apr. 20, 1988) (emphasis added).

18 *1995 Russian NME Review*, 60 Fed. Reg. at 16,443 (emphasis added).

II. The Department should be guided by Congressional intent and its own past practice in the current investigation.

Summary of comments. (1) Congress did not intend to limit NME status to countries with centralized government-run economies, but also contemplated situations in which subject economies were dominated by regional or local government authorities. (2) Congress did not intend "market economy" status to be conferred upon NMEs which were in the process of making a *transition* to market economy, but only to countries which had *completed* that transition successfully. (3) The Department must base its assessment on actual economic conditions in Russia, not on the mere existence of legislation, which, on its face, might be construed as evidence of the existence of a market-based system.

A. Congress did not intend to limit NME status to countries in which only the central government exercises pervasive control.

In general the NME statute enacted in 1988 established criteria that were virtually identical to those used by the Department prior to 1988. There was, however, one important distinction between the Department's prior practice and the wording of the new statute. In its case decisions preceding the legislation, the Department had utilized criteria which assessed the "degree of centralized government control over resource allocation" and the "degree of centralized government control over output."[19] The NME statute however, dropped the word "centralized" in the criteria applicable to government action, while retaining the remaining criteria utilized by the Department in prior cases. In so doing, Congress embraced a broader notion of government action, encompassing not only central but regional and local governmental entities. This broader definition of government action is important in the present investigation because much of the economic authority and ownership and control functions exercised by the central government under the Soviet Union has devolved upon regional and local authorities in the Russian Federation since 1991.

B. Congress intended that economies still "in transition" should retain full NME status.

Russia is commonly described as a country "in transition" from a nonmarket to a market economy. Its "transitional" status provides no basis for a finding that it has become a market economy. The NME statute was drafted to permit a change in the NME status *only* of countries that had fully transitioned into working market economies -- not countries "in transition," e.g. which had implemented an array of partially-effective and/or incomplete reforms. During the pendency of the NME legislation, while an NME determination including China was ongoing, the Committee for Fair Trade for China proposed to add a category of countries (to existing market and NME designations) called "Planned Market Economy Countries."[20] This proposed category was defined to include a nation implementing economic reforms that would eventually enable the country to have a working free market economy. Although intended to allow the U.S. to recognize "the sweeping political reforms occurring in countries like China," opponents to the proposal argued that the new category would reward countries that merely have planned market

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19 *Petroleum Wax Candles*, 51 Fed. Reg. at 6016; 51 Fed. Reg. at 25,085.

20 This was proposed by Committee on March 6, 1987.

economies and provide no incentive to actually move to a market economy.[21] The Department rejected this notion.[22]

C. The Department must ultimately rely upon de facto considerations when examining NMEs.

The Russian Federation's current request for market economy status relies heavily on the existence of various provisions and guarantees in the *text* of the Russian constitution and in national laws and regulations. While *de jure* considerations are one element of an NME determination, the *de facto* existence of the basic elements of a functioning market economy is the ultimate test of whether a change in status is warranted. The distinction between *de jure* and *de facto* circumstances is particularly important in a situation in which, as here, the subject country is characterized by a wholesale disregard for constitutional and legislative guarantees and the rule of law.[23] *De facto* circumstances were the Department's primary reasons for denying a change in Russia's status in 1995:

> *Many of the state controls have been abandoned, but that does not mean that functioning markets have replaced controls. Because the evidence does not demonstrate that prices and costs in Russia adequately reflect market considerations, we cannot at this time alter Russia's designation as a nonmarket economy.*[24]

The following sections apply the criteria established by Congress and developed and refined by the Department for determining the existence of a market economy to the actual circumstances prevailing in the Russian Federation.

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21 Other proposals put forth at the time were adopted, such as the sectoral analysis to determine whether a non-market economy product is the result of market or non-market forces.

22 The creation of a hybrid third category to encompass economies attempting to transition was subsequently rejected by Congress and by the Department when the issue was revisited in 1995. The Clinton Administration made two proposals to congressional committees designed to create interim designations, and changes in treatment under the U.S. trade laws, for NMEs in transition. These proposals were not adopted. The U.S.-Russia Business Council also proposed changes to both Congress and the executive branch to create a new category for economies in transition. Again, these proposals were rejected. *See* Robert H. Lantz, *The Search for Consistency: Treatment of nonmarket economies on transition under United States antidumping and countervailing duty laws*, 10 AM. U.J. INT'L L. & POL'Y 993, 1051, 1053 (1995) at 1053. (citing Carey et al., *Transitional Relief for Russia Under the U.S. Trade Laws: New Policies for Assisting Russia's Entry into U.S. and Global Markets*, U.S.-Russia Business Council (prepared by Steptoe and Johnson), sec. 1, at 3). "The economies in transition proposal would have been effective for five years, during which time no other United States unfair trade statute would apply to NMEs in transition." Lantz at 1051.

23 *See*, in particular, Sections V and VIII A and F of these comments.

24 *1995 Russia NME Review*, 60 Fed. Reg. at 16,443. The fact that NME reviews must focus on the actual state of the economy rather than mere progress toward a free market was recognized as appropriate by the Russians in the 1995 determination. The Department summarized the Russian views as follows: {C}onsideration of whether to revoke to revoke Russia's NME status should hinge upon whether there are concrete indicators of market-driven activity rather than on the degree to which the market has moved toward an orderly Western-style brand of capitalism."

III. Criterion 1: The extent to which the currency of the foreign country is convertible into the currencies of other countries.

Summary of comments. Numerous regulatory requirements limit the free convertibility of the ruble. Legislation which would liberalize these restrictions has been postponed for the foreseeable future.

Discussion. The first factor cited in the NME statute for determining the existence of a market economy is "the extent to which the currency of the foreign country is convertible into the currency of other countries. "[25] In a recent affirmative determination, the Department found that the Latvian *lat* has been convertible since 1994, that there were no restrictions on foreign exchange transactions, and that Latvian residents were "generally free" to make portfolio and direct investments abroad.[26] The Department also made affirmative market economy determinations in the Slovakia and the Czech Republic NME reviews, after finding that these countries had liberalized their foreign exchange regimes, but cited a number of remaining restrictions limiting full convertibility.[27] In the case of Russia, citizens are not free to make portfolio investments abroad, and restrictions more onerous than those cited in the Slovakia and Czech Republic cases continue to hinder free convertibility of the ruble. These restrictions have a significant negative effect on the commercial and investment environment, as well as important macroeconomic effects.[28]

A. Russia's currency is not freely convertible.

Residents in Russia face significant barriers to free convertibility of funds obtained or used in international commercial transactions. The IMF indicates that Russia's repatriation ratio for proceeds on exports is 100 percent, and the surrender requirement is 75 percent.[29] In other words, all foreign currency earned on exports from Russia must be returned to the country and exporters are *required* to exchange three fourths of all hard currency earnings for rubles within

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25 19 U.S.C. §1677 (1995).

26 U.S. Department of Commerce Internal Memorandum from C. Smith and K. Whitson to T. Cribb, Case No. A-449-804 at 6 (Jan. 10, 2001) ("*Latvia NME Review*").

27 Poland's zloty, for example, was freely convertible internally, but could not be freely exchanged outside of Poland for foreign investment goods, and capital account transactions remained restricted. U.S Department of Commerce Internal Memorandum from A. Hsu to the File, Case No. A-455-802 (June 21 1993) ("*Poland NME Review*"). *See also* U.S Department of Commerce Internal Memorandum from B. Carreau to R. LaRussa, Case No. A-859-801 at 4-5 (Oct. 13, 1999) ("*Slovakia NME Review*"); U.S Department of Commerce Internal Memorandum from J. Brinkman and N. Cannon to R. LaRussa, Case No. A-851-802 at 5 (Nov. 29, 1999) ("*Czech Republic NME Review*").

28 While it may be contended that residual restrictions on convertibility did not prevent the Department from recognizing Slovakia, Poland, and the Czech Republic as market economies, Russia's current convertibility restrictions are arguably more severe, and Russia fares far worse than the other countries with respect to the other criteria established by statute and Departmental precedent. Accordingly, the limited convertibility of the ruble, standing alone, does not warrant a finding that Russia is a market economy.

29 *Annual Report on Exchange Arrangements and Exchange Restrictions*, International Monetary Fund (2001), at 761 ("*Exchange Arrangements*"). Exh. 4.

10 days. The same restrictions apply to earnings on invisible transactions and on current transfers.[30]

Capital account purchases abroad by Russian residents require prior approval by the Central Bank of Russia.[31] According to the OECD, the "licensing system for such operations is both cumbersome to operate for the authorities and onerous and non-transparent for private sector participants."[32] The OECD has identified as a reform priority the elimination of the current system under which Russian firms "are unable to perform under legally binding commercial agreements because of the foreign exchange regulatory regime or its discretionary implementation by currency control authorities."[33]

Non-resident persons may use rubles to purchase foreign exchange only with balances held in so-called "I accounts," which are accounts used for investment purposes.[34] Funds held in accounts owned by non-residents for the purpose of investing in the government securities market ("S accounts") are subject to a one year waiting period for repatriation and conversion into other currencies.[35] Ruble balances held by non-residents in accounts used to conduct current international transactions and short-term non-government securities transactions ("T accounts") are also subject to conversion restrictions limiting repatriation of certain amortization payments.[36] These restrictions combine to limit convertibility of funds as well as the ability of non-residents to repatriate funds held in accounts used for both investment and commercial financing purposes.

B. Reform efforts have stalled.

Proposals to liberalize the restrictions on convertibility of the ruble appear to have stalled indefinitely. In mid-2001, the Ministry of Finance ("Misfin") and the Ministry of Economic Development and Trade were reportedly jointly tasked with preparing a "liberal law on currency regulation" which was to have gone into effect in 2002. However,

> *The draft was not prepared. Furthermore, the concept developed by Misfin in fact speaks only of the easements which have already been introduced, and proposes postponing total currency liberalization for 3-5 years.*[37]

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30 *Id.* Exh. 4.

31 *Id.* at 763. Exh. 4.

32 *The Investment Environment in the Russian Federation*, Organization for Economic Cooperation and Development (2001) at 15-16 ("*Invesmtent Environment in the Russian Federation*"). Exh. 5.

33 *Id.* at 16. Exh. 5.

34 *Exchange Arrangements* at 762. Exh. 4.

35 *Id.* Exh. 4.

36 *Russian Federation, Staff Report for the 2000 Article IV Consultation*, International Monetary Fund (Aug. 23, 2000) at 27 ("*Art. IV Report*"). Exh. 6. Balances accumulated after 1996 are not subject to these restrictions. *See Exchange Arrangements* at 761. Exh. 4.

37 "How Will Postponement of Currency Liberalization Influence Russia's Economy," *Moscow Vedomosti* (Oct. 22, 2001).

According to Aleksey Mamontov, President of the Moscow Interbank Currency Association, the delay in liberalization of the currency regime,

> *negates all efforts to improve the investment climate, the winning of new markets, and the change in the country's position in the international system of division of labor. The absence of serious progress in this direction casts doubt upon the ability of the Presidential authorities to overcome the sluggishness and inertia of the conservative wing of the government and the Central Bank.*[38]

38 *Id.*

IV. Criterion 2: The extent to which wage rates in the foreign country are determined by free bargaining between labor and management.

Summary of comments. In Russia, trade unions that purport to represent workers are weak or corrupt, strikes are widely considered illegal and are often suppressed when they do occur, and the government rarely enforces laws which purport to guarantee labor rights. Russian workers are severely restricted in their mobility by a Soviet-era registration system (propiska), are often "paid" in barter, and are commonly subject to arbitrary reprisals by their employers if they seek to improve compensation or working conditions.

Discussion. The NME statute provides that a subject country's transition to market economy status is to be determined, in part, by reference to "the extent to which wage rates in the foreign country are determined by the free bargaining by labor and management."[39] In its recent Latvia determination, the Department noted with approval a variety of "employee and employer freedoms" which,

> *Together with unrestricted labor mobility and an unemployment insurance program comparable to those of OECD countries, make it possible for both workers and employers to bargain over wages.*[40]

In the Slovakia and Czech Republic determinations, the Department cited labor-related laws and institutions safeguarding workers' rights, including the ability to form unions, collective bargaining and the right to strike.[41] Russia's labor policies and practices stand in considerable contrast to those examined in the Latvia, Slovakia, and Czech Republic determinations, and are an indicator that Russia has not developed conditions of free bargaining between labor and management which are characteristic of a market economy.

A. Because Russia lacks a true labor movement and enforceable worker rights, wage rates cannot be determined on the basis of "free bargaining."

Russia's current Labor Code addresses worker protections, including the right of association, the right to organize and bargain collectively, the prohibition of forced or compulsory labor, a minimum age for the employment of children, provisions for acceptable work conditions, and observance of worker rights in foreign investment sectors.[42] However, the Department utilizes a *de facto* analysis in its assessment of whether the labor practices of a subject country meet market economy standards, and in Russia, the worker rights embodied in the Labor Code are rarely protected.[43] Russia's Labor Inspectorate found more than 1.5 million

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39 19 U.S.C. § 1677(18)(B)(ii) (1995).

40 *Latvia NME Review* at 7-8.

41 *Slovakia NME Review* at 5-7; *Czech Republic NME Review* at 5-7.

42 *2000 Country Reports on Economic Policy and Trade Practices: Russia*, U.S. Department of State Bureau of Economic and Business Affairs(Mar. 2001) at 9-11, available at <http://www.state.gov/e/eb/r/s/rpts/cptp/2000/> ("*Bureau of Economic and Business Affairs*"). Exh. 7.

43 As in the 2001 NME review of Latvia, the Department has consistently looked to *de facto* labor conditions, considering workers' rights, trade union strength, wage bargaining, and labor mobility in the NME reviews of the Czech Republic, Slovakia, and Poland. In the Czech Republic, unlike Russia, tripartite collective

violations of the country's labor laws during the first nine months of 2000 alone, including 25,000 violations of collective agreements and contract procedures, 63,000 violations of work hour regulations, and 148,000 violations of worker payment legislation.[44] Other common examples of violations include interference in union elections and reprisals against striking workers.[45]

In 2000, Professor Boris Topornin, the director of the Institute of State and Law in Moscow and noted legal scholar, observed a pattern of disregard for the rule of law in the Russian system and criticized the current Labor Code for failing to protect basic human rights.[46] The Russian Constitutional Court found that the Labor Code as actually administered violated not only the Russian Constitution, but also the Universal Declaration of Human Rights, the Covenant on Economic, Social and Cultural Rights, and International Labor Organization conventions.[47] Although the Duma is in the process of rewriting the Labor Code, this proposed legislation has only passed the first reading, and in light of Russia's poor record of implementing legislation once passed, there is little reason to believe that these new provisions will be enforced with any more vigor than existing laws.

The absence of a true Russian labor movement and enforceable worker rights precludes any true "free bargaining" with management. According to Andrei Ryabov of the Carnegie Endowment in Moscow, "Russia has yet to develop trade unions that represent workers as their main task, and don't fear confrontation with authority"[48]

> *On paper, there is plenty of protection, for working conditions and trade-union rights in general. In reality, the unions' leaders are tame; the media give little coverage to labour issues; employers can do pretty much what they want; and anyone who steps out of line risks the sack, or worse.*[49]

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bargaining determines actual wage rates, workers are well represented by two main trade unions, and there are no government restrictions on labor mobility. In Slovakia, the Department found that tripartite wage negotiations had firm government support, workers were well represented by four major trade unions, and the right to strike was protected by the law. This labor environment is nonexistent in Russia. In the case of Poland, the Department found that workers were clearly negotiating wages with enterprises and that the government placed no restrictions on labor mobility. *Czech Republic NME Review* at 6-7; *Poland NME Review* at 30-32.

44 *Nations in Transit 2001: Russia*, Freedom House (2001) at 318, available at <http://www.freedomhouse.org/research/nitransit/2001/pdf_docs.htm> ("*Freedom House*"). Exh. 8; *Russian Federation: Annual Survey of Violations of Trade Union Rights (2001)*, International Confederation of Free Trade Unions (2001) available at <http://www.icftu.org/survey2001.asp>.

45 *Bureau of Economic and Business Affairs* at 10. Exh. 7. "Central and Eastern Europe Trade Unions Rights Bulletin No.30," International Confederation of Free Trade Unions (June 1, 2001), available at <http://www.icftu.org/displaydocument.asp? Index=991212942&Language=EN>.

46 Shara Abraham, *The Perpetuation of Legal Nihilism and the Assertion of Personal Freedoms in a Post-Soviet World*, 7 HUM. RTS. BR. 17 (2000).

47 *Id.* (citing a 1993 decision of the first Constitutional Court).

48 Fred Weir, "Russia's bold new proletariat," *Christian Science Monitor* (Sept. 6, 2001). Exh. 9.

49 "And what about the workers?" *Economist* (Dec. 9, 2000) at 58.

The large size of the labor movement belies its actual weakness as a force for worker rights. The Federation of Independent Trade Unions (FNPR), Russia's largest trade union, claims 40 million members, but the FNPR has historically actually hampered the advancement of labor rights.[50] The FNPR is a legacy of the Soviet era of compulsory trade unions, and still continues the practice of close relationships and long-standing ties with government and management.[51] Although the FNPR has worked to increase the political power of labor unions by endorsing and working to change labor legislation, most of these changes are aimed at maintaining its own privileged position. Workers view the FNPR as ineffective and corrupt, and indeed it consistently works to quash new unions which threaten its large power base.[52]

Independent trade unions are too weak to effect any actual change in light of the government's propensity to ignore labor legislation, their lack of political power, and the fact that the FNPR is often arrayed against them. While Russian workers have gone on strike to improve labor rights, strikes are still widely considered illegal and courts have the right to order employers to confiscate union property to compensate for losses from strikes.[53]

B. Workers' freedom of movement is severely restricted by the propiska registration system.

Workers' freedom of movement is severely restricted in Russia, a factor which significantly reduces their potential bargaining power. The Soviet era system of registry and residency permits, or *propiska*, remains in place, and effectively prevents workers from freely moving throughout the country.[54] Under this system – notwithstanding federal legislation designed to abolish it – regional governments require workers to be registered in the locality of their residence in order to be eligible for such necessities as health care, pensions, childcare. Changing residences – as might be necessary to pursue work opportunities in a different location – requires either the purchase of an apartment or registration by a new landlord, both of which are usually impossible.[55]

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50 Fred Weir, "Russia's bold new proletariat," *Christian Science Monitor* (Sept. 6, 2001). Exh. 9.

51 Linda J. Cook, "Trade Unions, Management, and the State in Contemporary Russia," in *Business and the State in Contemporary Russia*, Peter Rutland, ed. (Boulder, CO: Westview Press, 2001) at 151-152 ("*Cook*"); *Freedom House* at 318. Exh. 8; *FY 2001 Country Commercial Guide: Russia*, U.S. Department of State at 53 ("*FY 2001 Country Commercial Guide*"). Exh. 10.

52 *FY 2001 Country Commercial Guide* at 53. Exh. 10; *Bureau of Economic and Business Affairs* at 9. Exh. 7.

53 *Bureau of Economic and Business Affairs* at 10. Exh. 7. Some strikes are not even worker-led, as in the case of a strike at a Russian aluminum plant organized by a private security firm with organized crime connections, who donned workers' outfits, infiltrated the plant and encouraged the actual workers to strike against the local government. This and other similar "strikes" are more related to feuds between aluminum czars than the advancement of workers' interests. "The Lion is Moving in for the Kill," *Moscow Rossiyskaya Gazeta* (Sept. 23, 1999).

54 *Bureau of Economic and Business Affairs* at 11. Exh. 7; "Russia Survey: A reconditioned model," *Economist* (July 21, 2001) at 7; Global IDP Project, available under "Protection Concerns" at <http://www.db.idpproject.org/ Sites/ IdpProjectDb/ idpSurvey.nsf/wCountries/Russian+Federation>.

55 Human Rights Watch, "The Residence Permit System (Propiska)," available at <http://www.hrw.org/ reports98/ russia/srusstest-04.htm>; *Unlocking Economic Growth in Russia*, McKinsey Global Institute (Oct. 1999). Guido Friebel and Sergei Guriev, "Should I Stay or Can I Go? Worker Attachment in Russia" (Nov. 2000) at 2, 27, available at <http://www.gdnet.org/awards-shrtlist.htm>; *Russian Federation:*

C. Workers are commonly paid late or with goods rather than money, underscoring their lack of bargaining power.

Widely recognized examples of the real inability of workers to bargain freely for wages are the problem of wage arrears and the common practice of paying workers with goods rather than actual money wages. Although Russia has recently worked to improve on-time payments, non-wage payment still remains a significant problem, with total wage arrears amounting to $1.38 billion in April 2000.[56] The continuing deficiency in cash payments indicates that the use of non-monetary forms of compensation, such as social services and goods, is still widespread.[57] Russian managers are especially creative in their interpretation of what can be considered "compensation," with workers being paid with everything from canned pineapples to coffins, steel pipes, manure, and meat grinders.[58]

Labor reform efforts have made little progress. The government has set up a variety of institutions which nominally address labor rights, such as the Tripartite Commission for the Regulation of Social and Labor Relations, composed of representatives of Russian labor, management, and government. This body negotiates "General Agreements" with enterprises on issues such as wage levels, unemployment insurance, and safety net policies.[59] However, the General Agreements are not legally binding, and the Commission's recommendations carry little weight and are ignored by the government.[60]

Selected Issues, International Monetary Fund (Washington, DC: IMF Publications Service, Nov. 2000) at 27 ("*Russian Federation: Selected Issues*"). Exh. 11.; *FY 2001 Country Commercial Guide* at 53. Exh. 10.

56 *FY 2001 Country Commercial Guide* at 53. Exh. 10; *Freedom House* at 329. Exh. 8.

57 *Russian Federation: Selected Issues* at 27, n. 14. Exh. 11; *Cook* at 156.

58 Yevgenia Borisova, "Protestors Declare Labor Code Won't Work," *Moscow Times* (June 20, 2001); Vladmir Loktev, "You Cannot Put Pipe in a Wallet," *TRUD* (July 20, 1996).

59 *Cook* at 160.

60 *Id.* at 160-161; *Freedom House* at 318. Exh. 8.

V. Criterion 3: The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country.

Summary of comments. Russian law severely inhibits inward foreign direct investment, a problem which is exacerbated by extremely high tax rates, inconsistent regulation, and the failure to enforce existing laws to protect investors' rights. Reflecting these problems, Russia receives less than $14 per capita in FDI, compared with $436 for the Czech Republic and $277 for Slovakia.

Discussion. The NME statute provides the third criterion for determining the presence of a market economy is "the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country."[61] In all previous NME investigations, this has entailed an examination of both the laws of the foreign country, as well as how those laws are actually implemented and enforced.

Latvia's liberal policies with respect to FDI were a significant factor in the Department's recent determination that it had become a market economy, as it was for other NME reviews.[62] The Czech Republic's openness to FDI and the relatively large amount of FDI which had occurred were likewise factors in the Department's affirmative determination of transition to market economy status.[63] Slovakia was found to be relatively open to FDI, although the Department noted some factors which tended to inhibit inward foreign investment.[64] Russia is deficient in positive factors affecting FDI cited by the Department in its Latvia and Czech Republic determinations, and the negative factors deterring FDI identified by the Department in its Slovakia determination are present to a much more aggravated degree in Russia. In light of these comparisons, Russia fails to satisfy the third statutory factor necessary to demonstrate a market economy.

A. Legal and regulatory impediments limit foreign direct investment.

Russian laws prohibit many forms of FDI and severely restrict the rights of foreigners with respect to joint ventures. Coupled with significant government ownership in most sectors, such restrictions inhibit or prevent foreign investors from exercising control over their investments. The letter of Russian Federation law states that investors' rights are protected by investment guarantees and federal legislation, and as a technical legal proposition, FDI is guaranteed the same treatment granted to Russian nationals. Foreign investments have not been

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61 19 U.S.C. § 1677(18)(B)(iii) (1995).

62 *Latvian NME Review* at 8-10. The Report next found that Latvia has a "generally favorable business environment," all sectors of the Latvian economy are open for investment, and one hundred percent ownership of a company is permitted. Additionally, where operating and licensing requirements restrict investment sectors, such requirements do not treat foreigners differently, but apply to both Latvians and outside investors. While the Department mildly noted that in Latvia "{c}orruption is undermining business confidence and the rule of law," the extent of organized crime's influence in Russian business and industry has become notorious worldwide.

63 *Czech Republic NME Review* at 6-7.

64 *Slovakia NME Review* at 7-8. The NME review for Slovakia noted that FDI is permitted in most sectors, although foreigners could not own real estate or acquire shareholdings in strategic sectors such as gas, electricity, telecommunications and armaments production.

subject to expropriation as a formal legal matter since 1991.[65] The U.S. State Department notes, however, that "in practice these protections have yet to be codified, since the implementing regulations are still lacking."[66] The U.S. Embassy is currently tracking a series of cases brought by foreign investors to recover property and investments expropriated by regional governments in the Federation – an exercise which has thus far proven fruitless.[67] The failure to enforce supposed protections is the rule rather than the exception.

> *Foreign investors participating in Russian privatization sales are often confined to limited positions and face problems with minority shareholder rights and corporate governance.*[68]

With respect to joint ventures, Russian banking laws inhibit project finance, as lenders are prohibited from taking effective security over bank account balances, mining licenses or business interruption insurance. Russian insurance law only permits Russian entities to take out insurance with Russian insurance companies, necessitating that the local insurer re-insure the underlying claim with an international insurer to sufficiently guarantee the coverage to foreign standards. Russian law does not allow the benefit of a reinsurance contract to be transferred to any entity other than a Russian insurance company, and all payment must be made in rubles. These impediments to joint ventures have contributed to the failure of some joint ventures.[69]

Foreign investors are prohibited by law from owning a controlling stake in several industries.[70] Under Russian corporate law, ownership of 28 percent is necessary to exercise a veto; but, in sectors where the laws limit ownership, total foreign ownership is capped at 25 percent or less. Foreign investors are thus unable to utilize veto powers when necessary to protect their investments.

Bureaucratic actions, particularly arbitrary and uneven enforcement of Russian tax law, inhibit FDI. As noted by the U.S. State Department, "High tax levels and extremely high costs of complying with the Russian tax regime, inconsistent government regulation, the inability of

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65 Letter from Novolipetsk Iron & Steel Corporation. to the U.S. Department of Commerce, Case No. A-821-816 at 10-11 (July 26, 2001) ("*Memorandum of the Russian Federation*").

66 *FY 2001 Country Commercial Guide* at 44 (discussing both the 1991 Investment Code and the 1999 Law on Foreign Investment). Exh. 10.

67 *Id.* at 47 (noting that, to date, no award payment had been made). Exh. 10.

68 *Id.* at 45. Exh. 10.

69 The parties involved in this transaction make it clear that such restrictive rules are a clear sign of an emerging market, not an economy that has transitioned into a free market. *See* Ian R. Coles, *The Julietta Gold Mining Project: Lessons for Project Finance in the Emerging Markets*, 24 FORDHAM INT'L L.J. 1052, 1062 (April 2001).

70 FDI is explicitly limited in numerous sectors, including the aerospace industry (25% total foreign ownership); the natural gas monopoly, Gazprom (20% total foreign ownership); the banking industry (foreign equity in total industry limited to 12%), in electric power giant UES (25% total foreign ownership); and a complete prohibition on FDI in companies that sell life or compulsory insurance. *FY 2001 Country Commercial Guide: Russia*, U.S. Dept. of State at 45 (July 2000). Exh. 10. *See also Investment Environment in the Russian Federation* at 45-50 (discussing specific regulations and industries and the enforcement of FDI limitations). Exh. 5.

some investors to obtain redress through the legal system, and crime and corruption all dissuade investors. These systemic problems are exacerbated by weak purchasing power, lack of financing, and concerns about economic and political stability."[71] Most simply, "It is not the marginal effect of a rising real exchange rate, but Russia's bureaucracy, along with taxes and bad management, that really holds back growth."[72] As the U.S. State Department recently observed:

> *Uneven implementation of laws creates further complications; various officials, branches of government and jurisdictions interpret and apply regulations with little consistency and the decisions of one may be overruled or contested by another.*[73]

B. Russia's failure to enforce existing laws protecting foreign investment deters investment.

To the extent that protection of foreign investors has become embodied in Russian law, the failure to enforce laws generally has created an environment in which the rights of all minority shareholders are not safeguarded and the most basic of corporate governance obligations are often unfulfilled. In many cases criminal elements exercise the greatest influence in determining shareholder votes, takeover bids, and the outcome of judicial enforcement of corporate laws.

As frequently stated by the IMF, the rule of law and a legal system that enforces property rights and contracts are "essential foundations of the environment for investment."[74] However, the IMF, the EBRD and other international financial institutions and investment groups have experienced firsthand that such foundations are still not present in the Russian Federation. According to some reports several of Russia's industry leaders, including Gazprom, Lukoil, UES, Sberbank, and Norilsk Nickel, are openly fleecing minority shareholders and publicly ignoring accounting and auditing regulations.[75] A recent World Bank report found that there is a 90 percent probability of losing foreign direct investment in Russia within five years, as compared with a 25 percent in Hungary.[76]

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71 *FY 2001 Country Commercial Guide* at 44. Exh. 10.

72 "Good in part" *Economist* (July 19, 2001).

73 *FY 2001 Country Commercial Guide* at 48. Exh. 10.

74 Michel Camdessus, Managing Director of the International Monetary Fund, *Address Before the High-Level Segment of the 1999 Substantive Session of the UN Economics and Social Council* (July 5, 1999), in M2 Presswire, July 7, 1999, at 4, available in Lexis, News Group File.

75 "Minority what?" *Economist* (February 22, 2001) (discussing recent examples from each company).

76 *Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition*, World Bank (2000). "*{I}n Russia where adequate law does not secure valued resources the risks of economic activity become prohibitive in many instances, and the economy has stagnated or declined.*" O. Lee Reed, *Law, the Rule of Law, and Property: A Foundation for the Private Market and Business Study*, 38 AM BUSS. L.J. 441, 458 (2001).

As noted by the OECD, the judicial system's treatment of investors' rights cases is woefully inadequate.

> *There is no special procedure for handling petty disputes and no special courts with different areas of specialisation {sic} to develop the necessary expertise for more complex issues. Investors are in fact often deterred from taking cases to court by the lack of independence of judicial procedure and long delays due to court workloads. Judges, bailiffs and other court officials tend to be too inadequately remunerated to ensure their commitment to protecting the rights and interest of plaintiffs or enforcing court rulings.*[77]

Foreigners, as well as nationals, who attempt to start businesses face crippling bribery demands and byzantine bureaucratic obstacles to their investment projects.[78]

> *The rule of law and respect for property rights, although gradually showing some improvement over the years, remains a key concern for foreign investors.*[79]

Protection of investors' rights under Russian law is so poor that U.S. investors have begun to use U.S. courts and the American Racketeer-Influenced and Corrupt Organizations statute (RICO) to bring suits alleging illegally lost profits.[80] Although the Putin government has promised several reforms of laws related to investors, joint-stock companies, bankruptcy, insider trading, and the securities market, these draft laws have been stalled in the Duma, some of them since 1999.[81]

C. Russia's weak system of corporate governance dramatically increases risks to foreign investors.

The state of effective corporate governance and the transparency of corporations was a consideration in the 1999 NME reviews of the Czech Republic and Slovakia. Although the need for general improvement in industrial and banking sectors was cited, the Department noted that the industries of both countries were successfully competing on the world markets. Additionally, the Department cited significantly increasing levels of foreign direct investment as proof that corporate governance standards were improving. In light of the abysmal levels of FDI inflows to Russia $14 per capita -- compared to equivalent levels of FDI in Slovakia at its NME review --

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77 *Investment Environment in the Russian Federation* at 44. Exh. 5.

78 *See* "Good in part" *The Economist* (July 19, 2001) (discussing the stalled business project of British businessman, Clive Rumens, in Novorossisk). *See also Strengthening Investor Protections*, US-Russia Business Council (June 5, 2000) available at <http://www.amcham.ru/invprotect.htm> (noting that "there are numerous examples of both Russian and foreign investors; rights being abused.")

79 *FY 2001 Country Commercial Guide* at 46. Exh. 10.

80 "From Russia with RICO for U.S. attorney," *The Russia Journal* (Sept. 28, 2001), available at <http://www.russiajournal.com/weekly/article.shtml?ad=5230>.

81 *See Strengthening Investor Protections*, U.S.-Russia Business Council (June 5, 2000) (discussing amendments to the Law on Protection of the Rights and Legal Interest of Investors in the Securities Market, the Law on Joint-Stock Companies, the Law on Insolvency, the Law on the Securities Market, and the Draft Law on Affiliated Parties).

$314.80 per capita -- it is clear that there are serious corporate governance problems in Russia, indicative of a nonmarket economy.[82]

> *A lack of clear, accurate and widely accepted business practices is costing Russia $10 billion a year in direct foreign investment.*[83]

Western experts agree that corporate governance is not measured by examining national corporate laws, but rather when corporations "both maximize the firm's residuals—the wealth generated by real operations of the firm -- in the cause of investor-owned firms, distribute the wealth so generated to shareholders in a pro rata fashion."[84] Low valuations and FDI levels "reflect severe corporate governance problems, including the high probability that the firms' underlying assets will be mismanaged grossly and that whatever cash flow is produced will be diverted to benefit insiders or reinvested in unproductive projects."[85]

The lack of trust in Russian corporations results in a serious undervaluing of assets held by Russian corporations; for example, a barrel of proven oil reserves owned by a Russian company is worth about one-twentieth of a similar barrel owned by a Western oil company.[86] Troika Dialog, the biggest Russian brokerage firm, estimates that bad corporate governance accounts for a $54 billion discount on the value Russian equities would otherwise hold.[87] The failure to make pro rata distributions is a notorious and ongoing problem since the beginning of privatization. Other frequent corporate governance failures include the refusal to register shares purchased by outsiders, the failure to recognize board directors properly elected by outside shareholders, and fake bankruptcies designed to wipe out shareholder interests.

Because existing laws regulating corporate affairs are so ineffective, a *de facto* analysis of corporate governance issues is the key to fully understanding the failings. As one observer noted,

> *Russian companies have a near perfect record. In fact, Yukos {a notorious abuser of shareholder rights} shareholders could never prove in court that their rights have been violated. This is a red flag that the law is imperfect.*[88]

Under current law, the Russian Securities Commission's only recourse against a company that has violated investors rights or securities laws is a maximum fine of $10,000 and the right to deny new share issues. A new law regulating the registration and reorganization of corporations

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82 *2001 Transition Report Update*, European Bank for Reconstruction and Development (April 2001) at 22. Exh. 13. FDI inflows in 1999 were even more abysmal in 1999, at $5 per capita. *Id.*

83 Alla Startseva, "PwC Study: $10Bln Lost to Opacity Every Year," *The Moscow Times* (April 25, 2001).

84 Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons from Russian Enterprise Fiascoes*, 75 N.Y.U. L.R. 1720, 1722 (2000) ("*Corporate Governance*"). Exh. 12.

85 *Id.* at 1721. Exh. 12.

86 *Id.* at 1722. Exh. 12.

87 "Minority What?" *Economist"* (February 22, 2001).

88 Torrey Clark, "In Search of Corporate Governance," *Moscow Times* (May 28, 2001).

and legal entities, drafted in conjunction with the EBRD, is scheduled to enter into force in July 2002. However, this newly drafted law, intended to amend the Russian Civil Code, already shows shortcomings and inconsistencies.[89] In a move that undermines any potential effect, the Russian Securities Commission has proposed that the new laws only be advisory for the first four years after implementation.[90]

> *Russia ranked last in a recent survey of corporate governance practices in twenty-five emerging markets.*[91]

The continued failure to enforce laws regarding corporate management, the frequent abuse of minority shareholders, and the rampant underreporting of assets for the purposes of evading taxes all demonstrate a disregard for market economy standards. Currently, no major corporations follow general accounting practices, and the Russian news considered it a major event when Vipelcom announced they would issue a quarterly report. Inaccurate accounting, often deliberate to undervalue assets for creditors and tax purposes, affects even the corporation's own workings. The Baltic Shipping Company even reported that, {I}t's difficult to say how many ships we have in operation, because at any moment, we could get another call saying another ship has been seized by creditors."[92] The inability of investors to accurately value the assets and potential of Russian corporations, as well as the return on any investments, discourages investments in all sectors. Investors who observe corporations going unpunished for violating shareholder rights have no faith that their own rights will be protected, no matter how stellar the record of any company's shareholder protection.

> *The Russian process of unfriendly takeovers is radically different from a market-based one. In a market economy, the unfriendly invader pays more for the company that in a friendly absorption. In the Russian economy, he does not pay anything, not counting paying for the upkeep of various military formations -- courts of arbitration and Special-Purpose Police Detachment officers -- and using up munitions.*[93]

Regardless of corporate governance failures, investors face the dilemma of investing in corporations that do not even own the land under their factories. Despite privatization efforts, regional authorities still resist the privatization of land and maintain ownership rights as a source of power in dealing with local enterprises.[94] Although Putin, in October 2001, signed a law allowing the privatization of land, only three percent of Russian lands will be affected, as all

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89 For example, under the new law, companies would only register with the federal government, however, the new law also retains a provision stating that companies are also "subject to state registration by judicial bodies." *See* BNA's Eastern Europe Reporter at 17.

90 Ana Uzelac, "Cabinet Says Yes to Corporate Governance," *Moscow Times* (Nov. 29, 2000).

91 Bernard Black, *Does Corporate Governance Matter?: A crude test using Russian data*, 149 U. PA. L. REV. 2131, 2135 (June 2001) ("*Black*"). Exh. 14.

92 *Corporate Governance* at 1734. Exh. 12.

93 "Russian 'Industrial Feudalism' Described," *Moscow Novaya Gazeta* (Mar. 26, 2001). Exh. 2.

94 *Corporate Governance* at 1754, n.137. Exh. 12.

"agricultural" land is exempted. Basically, a system of "industrial feudalism" will persist, and with it corporate uncertainty.

> *We can say that it is not so much property that is in private ownership in Russia but instead {private ownership of} the law, the army, and the right to collect taxes—that is to say, everything that does not belong to private individuals in a market economy.*[95]

Despite repeated analysis concluding that stronger corporate governance rules and increased transparency would significantly boost firm value, most firms resist, stating that adherence to "Western corporate standards" would cost too much. Nearly all firms ignore reports that up to a seven-fold increase in firm value would result if the worst violators of shareholder rights changed their practices.[96] This begs the question whether managers are more concerned about increased firm costs, or decreased personal skimming, that would result from better corporate governance.

D. Russia's very low FDI reflects Russia's shortcomings.

In 2001, PricewaterhouseCoopers reported that Russia loses approximately US$10 billion every year to the non-transparency of the country's economy.[97] Another observer remarked on the fact that Russia's levels of FDI are most demonstrative of the lack of opportunities for true investment, especially in light of the FDI levels in other countries whose status has recently changed from NME to market economy. Compared to countries like the Czech Republic and Slovakia, whose 2000 FDI levels per capita are $437 and $278 respectively, Russia receives only $14 per capita in FDI.[98] Furthermore the distribution of this money is extremely skewed, as FDI is nearly non-existent in the regions outside Moscow and St. Petersburg; the remaining 85 regions play host to less than two percent of the country's FDI.[99]

95 "Russian 'Industrial Feudalism' Described," *Moscow Novaya Gazeta* (Mar. 26, 2001). Exh. 2.

96 *Black* at 2132. Exh. 14.

97 "PwC Study: $10 Bln Lost to Opacity Every Year," *The Moscow Times* (April 25, 2001).

98 *2001 Transition Report Update* at 59, 85, 87. Exh. 13. Latvia, who most recently transitioned, received $166.25 per capita in FDI in 2000. *Id.* at 75.

99 Harry G. Broadman & Francesca Recanatini, *Where Has All the Foreign Investment Gone in Russia?* World Bank, Poverty Reduction and Economic Management Sector (July 2001) <http://econ.worldbank.org/files/2319%5Fwps2640.pdf>. *World Development Report 2002: Building Institutions for Markets*, World Bank (Nov. 2001) at 239; State Committee of the Russian Federation on Statistics (Goscomstat) (Nov. 14, 2001) available at <http://www.gks.ru/scripts/eng/1c.exe?XXXX09F.141.1/010150R>; *Investment Environment in the Russian Federation* at 62. Exh. 5; *2001 Transition Report Update* at 85. Exh. 13.

VI. Criterion 4: The extent of government ownership or control of the means of production.

Summary of comments. The only privatization occurring in Russia since the breakup of the Soviet Union has taken place in peripheral sectors of the country's highly concentrated economy, leaving government ownership and control largely intact in Russia's core industries. In such core sectors, to a considerable extent, "privatization" has involved a mere transfer of ownership from one government entity to another, or has culminated in "renationalization" as ownership has passed from private hands back into those of a federal, regional or local government entity. The Russian government's privatization program has been at a near standstill since the onset of the Russian financial crisis in 1998.

Discussion. The fourth criterion established by Congress to determine transition to a market economy is "the extent of government ownership or control of the means of production."[100] The Department has considered the inability to fully satisfy this factor as grounds for not transitioning to a market economy. In fact, the Department pointed to *partial* government ownership as evidence *against privatization progress*:

> *{E}ven though the Government of Ukraine's submission indicate that in 1995 and 1996, 34% and 44% respectively of state-owned enterprises were privatized, it is unclear whether those figures reflect 100 percent privatization of the enterprises in question, or some continued level of government ownership....*[101]

In the Latvia determination, the Department found that by the end of 1998, as a result of government privatization efforts, "virtually all enterprises were in private hands, and the private sector accounted for 65 percent of GDP."[102] In the Slovakia determination, the Department found that by the end of 1997, less than 3 percent of Slovakian enterprises were state-owned and the private sector accounted for 75 percent of GDP.[103] In the Czech Republic determination, the Department found that by the end of 1997 the private sector accounted for 75 percent of GDP.[104] Russia's present situation with respect to government ownership and control stands in sharp contrast to all three of these recent determinations. Russian government ownership and control of the productive enterprises that constitute the Russian economy remains extensive and progress toward further privatization has been at a standstill for at least three years.

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100 19 U.S.C. § 1766(B)(iv) (1995).

101 *Cut-To-Length Carbon Steel Plate From Ukraine*, 62 Fed. Reg. 61754, 61756 (Nov. 19, 1997) (Final Determination of Sales at Less Than Fair Value).

102 *Latvia NME Review* at 12.

103 *Slovakia NME Review* at 10.

104 *Czech Republic NME Review* at 11.

A. The Russian Federation's claim that only 25 percent of economy is based on "state enterprises" is unsupportable.

The Russian Federation's submission claims that as a result of privatization efforts, "a private sector, which produces more than 75 percent of the Russian GDP, has emerged in Russia."[105] The Russian government does not provide specific data to support this claim, but it is evident from independent data that this figure is inflated substantially by several factors: (1) the Russian Federation's definition of "private enterprises" apparently includes enterprises that are partially private but partially government owned and controlled; (2) companies "privatized" by the federal government but purchased by other governmental entities may be considered to be in "private" hands; (3) in many significant cases, after a privatization has been ostensibly completed, regional and local governments have stepped forward to acquire ownership and/or control of a nominally "private" enterprise.

Official Russian government data on *ownership* of Russian enterprises are maintained by the Ministry of State Property (MSP), which oversees much of the privatization program, and the Ministry of Economic Development and Trade (MEDT). These data sources are cited by the Russian Federation in support of the claim that Russia meets the criteria for being a market economy.[106] The MSP reports that only 12 percent of *the number* of enterprises[107] are "state enterprises." Given the extreme concentration of economic activity in large enterprises in Russia, however, the *number* of enterprises under government ownership or control is not a very useful measure of government ownership and control. The Russian government itself estimated that there were 890,500 small businesses in 1999, but that these comprised only 6.2 percent of the Russian economy.[108]

B. Independent surveys undercut the Russian Federation's privatization claims.

As part of its effort to facilitate the Russian privatization program, until the year 2000 the World Bank maintained what the Bank called Russian "privatization transaction data" for large-scale companies.[109] **Table A** presents the information contained in the World Bank database. World Bank officials confirm that this table has not been updated since the year 2000 (listing transactions through 1999), but that this is due to the hiatus in major privatizations since the Russian financial crisis – so that data in this table can be considered to reflect a reasonably

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105 *Memorandum of the Russian Federation* at 18.

106 Id.

107 The Russian government also claims that only 12 percent of the enterprises in Russia are "state enterprises." Moreover, it is unclear how the government defines "state enterprises" and, as described below, it is likely that enterprises with some private ownership but that retain significant government ownership and control are counted as not "state owned."

108 *Banking and Stock Exchange* report of ITAR-TASS article, "Small Enterprises Manufacture 6 Percent of Goods Produced in Russia," *Moscow Vedomosti* (Oct. 11, 2000) at B6.

109 Download from http://www.ipanet.net/documents/WorldBank/databases/plink/soceco/1russia.htm (Oct. 2000).

accurate view of the current situation.[110] Correlation with other, independently published data suggests that this table is highly representative of Russia's large-scale privatizations.[111]

An April 2001 EBRD report substantiates the World Bank's conclusion that large-scale privatization has virtually halted.[112] In fact, previous privatization did not significantly change levels of government control:

> *Despite rapid large-scale privatization in 1992-1995, the Russian state sector remains extremely large. On 1 January 2001, according to the United Enterprise Register, there were 367,400 organizations with state or municipal ownership, 2,509,600 privately owned, and 144,500 with mixed ownership.*[113]

Furthermore, the EBRD classifies Russia's privatization of large-scale enterprises as having achieve a "3+" rating.[114] The relevant rating descriptions are:

> *Rating 3: "<u>More than 25 percent</u> of large-scale enterprise assets in private hands or in the process of being privatized (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance."*

> *Rating 4: "<u>More than 50 percent</u> of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises."*[115]

By giving Russia a "3+" rating, the EBRD has determined that Russia has not achieved even a 50 percent level of privatization for large-scale enterprises, and furthermore, the EBRD does not believe these enterprises will be privatized in the near future.

Examination of the "privatization" that major Russian companies experienced, reflected in the World Bank data in **Table A**, suggests that the government could not, in fact, have

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110 Telephone interview (Oct. 2001). Note that the incomplete nature of the data collected by World Bank suggests that *any* data on government vs. private ownership in Russia is not comprehensive.

111 For example, the Table provides government revenue (sale) amounts for 52 of the 69 listed transactions, totaling $8.27 billion, or $57 per capita. The population of Russia is 145 million. CIA *World Factbook* 2001, "Russia." The European Bank for Reconstruction and Development (EBRD) recently published a chart showing that the Russian government's revenues from privatization -- which would include the many tens of thousands of small enterprises not covered by the World Bank data -- were around $100 per capita, which suggests that the World Bank table is somewhat comprehensive. *2001 Transition Report Update* at 23. Exh. 13.

112 *2001 Transition Report Update* at 23. Exh. 13.

113 *Russian Federation: Investment Profile 2001, EBRD Business Forum (April 2001) at 13. Exh. 15.*

114 *Transition Report 2000: Employment, skills and transition*, European Bank for Reconstruction and Development *(Nov. 2000) at 14 (emphasis added). Exh. 16.*

115 *Because* Russia is a "3+" their total level of large-scale privatization must be around 35 percent. *Id.* at 15. Exh. 16.

relinquished ownership of Russian industry anywhere near the degree suggested by the "75 percent private" figure cited by the Russian Federation.

- First, the simple, *unweighted* average of the share of each company sold in these 69 major privatizations was less than 39 percent -- *i.e.*, on average, far less than half of the company is being sold at any one time. See column ***a*** of **Table A**. A glance through the table shows that even this low figure is being skewed upward by six companies in the textile sector that were 100-percent privatized.[116] As shown in **Figure 1**, even taking into account the fact that some of these "privatizations" represent multiple offerings of the same company, and therefore a larger percentage of the company being sold in aggregate, the state is often left with very large -- even dominant—holdings

- Second, when the World Bank data are *weighted* by the value of the enterprise subject to the sale, it is clear that very little of the "privatization" sales by value resulted in more than 50 percent of the companies being transferred, as shown in **Figure 2.**[117] Indeed, as can be seen on **Table A**, \$1.75 billion of the \$8.27 billion, or 21 percent, of the total value sold is accounted for Gazprom alone, an entity which Russian antidumping respondents acknowledge remains to be privatized.[118]

- Third, as further evidence of the incomplete nature of the Russian privatization program, of the six major companies cited[119] by antidumping respondents as being part of Russia *future* privatization plan (supposedly as evidence Russia's good intentions with regard to privatization), four appear on the World Bank table of major *past* privatization transactions: Gazprom, LUKoil, Svyazinvest, and Slavneft. Indeed, these four yet-to-be-privatized companies account for eight of the 69 transactions listed, and a remarkable <u>50 percent</u> of the total sales value of the so-called "privatization transactions."

C. The Russian Federation's definition of "private" shareholders appears to include Russian governmental entities and international governmental organizations.

A review of the World Bank data, as presented in **Table A**, shows that some "privatization" transactions consist of the sale of shares by the federal government to another entity controlled by the federal government. For example:

- In 1999, 58 percent of Neftochim, a mining and quarrying company (Table A, line 33), was "privatized" through a sale of shares to LUKoil, a multi-billion dollar Russian

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116 Excluding these six textile companies reduces the average to less than a third.

117 The value of the enterprise is calculated by extrapolating the value on the share sold to 100 percent of the shares of the company. For example, if 25 percent of the company is sold for \$100 million, then the company's value is assumed to be \$400 million. Because of the depressing effect of government ownership on value to private investors, this simple arithmetic might not be appropriate in all cases.

118 *Memorandum of the Russian Federation at 17.* Gazprom is cited as a company that Russia is "planning" to privatize.

119 *Id.*

government-controlled petroleum concern that has itself had very few shares privatized (Table A, lines 25-27). Indeed, as recently as July 2001 Russian antidumping respondents cited the Russian government's *plans* to privatize LUKoil as an example of Russia's seriousness about privatization.[120]

- In 1996, 8.5 percent of UES, Russia's dominant electricity supplier (Table A, line 60), was "privatized" through the sale of shares to Gazprom, itself a government-owned and -controlled entity, as acknowledged by respondents.[121]

Gazprom, Russia's largest company, is a good example of how convoluted the Russian government's "privatization" arithmetic can be. Since the mid-1990s, government-run Gazprom has been on a company buying-spree, purchasing nominally private enterprises such as television stations.

Finally, many of the Russian "privatization transactions" are little more than cash injections by foreign governmental financial assistance agencies. For example, as part of its "privatization" program, the Russian government recently announced that it might sell 20 percent of the country's second-largest bank, Vneshtorgbank, to the EBRD, a supra-national, non-commercial governmental entity.[122]

D. Regional and local governments have "de-privatized" or "re-nationalized" many companies.

Often former state-owned factories that are nominally privatized by the federal government become, in fact, companies under the control of regional and local governments.[123]

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120 *Id.*

121 *Id.*

122 "Russia Will Sell 39% of state-owned insurer And Put Off Decision on Bank," *The Wall Street Journal Europe* (Oct. 26, 2001).

123 As summarized by one study: "Regional and municipal governments have also re-asserted property rights claims in the wake of the August crisis. Since mid 1998, de facto renationalizations of previously privatized property have taken place among several well-known corporations. The Belgorod iron-ore combine, Alkar Aluminum in Sverdlovsk, Kransnoyarsky Metalurgichesky Zavod, Mikhailovsky Iron Works, Tatneft, Kamaz, Avtovaz, Zil, and Moskvitch all underwent partial renationalization by the end of 1998. In 1999, further takeovers have occurred in Sverdlovsk, Ulyanovsk, Krasnoyarsk, Voronezh, Primorye, Chelyabinsk, and Moscow. In oil producing regions, shares of several oil companies found their way into regional governments or regional government-owned companies - including Komineft (Yamalo-Nenetsky), and ANKH (Irkutsk). First, several "regional investment vehicles" under the protection of local governments have been set up in order to consolidate regional government holdings in important local industries. In some cases these are simply regional government-owned holding companies, which may have attempted to increase their shares through a capital increase. In other cases the regional governments have restructured debts owned by corporations by converting those debts into equity. Second, companies have invoked a 1996 Presidential Decree on wage and tax arrears, repaying their tax debts to regional and federal budgets by issuing new stocks. In one case - YUKOS - newly issues shares wound up in the hands of a private owner (in this case, the Menatep Group), and the revenues from those shares were transferred to the budget. In all other cases, however, the government shares have increased in companies under this arrangement." Raj M. Deai and Itzhak Goldberg, *The Vicious Circles of Control: Regional Governments and Insiders in Privatized Russian Enterprises* at 10.

Such "de-privatizations" are quite common, but can be seen only through examining specific companies and industries at the local levels. Among Russia's six "privatized" second-tier regional steel companies, for example, three have found themselves back largely under government control:

- **Kuznetsk** was falling into bankruptcy when the Kemerov regional government supported "transfer of the works into state hands" and sought to prevent it "from passing into {new} private ownership."[124] The government blocked the scheduled sale of shares by the then majority private investor and management company, Mikom.[125] The regional government arrested both the local Kuznetsk union leader and its then external administrator, whom it replaced with an external administrator of its choice. According to Mikom, the Kemerov government sought control over the mill for "access to its finances {to use} these for political ends."[126] Subsequently, Euras-Holding became the majority shareholder in Kuznetsk, apparently with the blessing of the regional government as the mill is scheduled to remain under government control until 2008.

- **Zapsib** was initially declared bankrupt and put under external management by a major creditor in June 1997. Many of its creditors were government entities and the company was granted an extended moratorium by the regional government.[127] In March 1999, the city of Novokuznetsk and the Kemerov Regional Government assumed external management of the mill, requiring ownership equity in exchange for outstanding debts. The government's share of ownership in Zapsib hovered at about 23.79 percent during the attempted bankruptcy proceedings. That share was recently diluted to 4.2 percent when Euras-Holding consolidated its stake at 75 percent,[128] but Euras-Holding reportedly "presented the government with a gift of shares" in its acquisition of Zapsib stocks in 2001, thereby "winning its {the government's} support" and paying off the company's debts to the government.[129]

- **Nizhny Tagil** was "essentially bankrupt" and "virtually moribund" when it was put under external management in April 1998, but was "not allowed to go bankrupt" by the Sverdlovsk regional government.[130] The mill owed between 8 and 9.5 billion rubles at that time, primarily

124 "Court Postpones Kuznetsk Sale," *Metal Bulletin* (Nov. 1, 1999); "Local Court to Decide Kuznetsk's Fate," *Metal Bulletin* (Oct. 28, 1999).

125 "Court Rings Changes at Kuznetsk," *Metal Bulletin*, (Nov. 22, 1999); "Court Postpones Kuznetsk Sale," *Metal Bulletin* (Nov. 1, 1999); direct regional government involvement in KMK's administration is in evidence at "New Administrator for Kuznetsk," *Metal Bulletin* (Feb. 10, 2000); "KMK Creditors Back a New Administrator," *Metal Bulletin* (Jan. 20, 2000); "New Director Appointed at KMK," *Metal Bulletin*, (Dec. 6, 1999); "Tensions Rise at Kuznetsk," *Metal Bulletin* (Dec. 2, 1999).

126 "Kuzbass Governor Calls for Steel Mill Merger," *Interfax Metals and Mining Report* (June 11, 1999).

127 Interfax Eurasia Business Report for 10-15 Jan. 2000; "Siberian Mills Resume Bankruptcy Battles," *Metal Bulletin* (Jan. 2000); "West Siberian Steel Works Sets Up New Trading Co.," *Interfax Metals and Mining Report* (Sept. 9, 1999); "Local Government to Head Zapsib Until 2007," *Metal Bulletin* (Mar. 1999).

128 "Building of Russian Steel Continues in Siberia," *Metal Bulletin* (Sept. 20, 2001).

129 *Id.*

130 "Nizhny Tagil Seeks Agreement with Creditors," *Metal Bulletin* (Nov. 29, 1999); "Magnitogorsk Blasts Decision to Build Mill-5000 in Nizhny Tagil," available at <http://www.europe-steel.com> (May 18,

to the government-owned gas and electricity suppliers, such as Tagilenergoremont.[131] Motivated by the potential loss of "the biggest taxpayer to the local budget," the Regional Sverdlovsk Government repeatedly intervened in the court bankruptcy proceedings of Nizhny, demanded a 25 percent (blocking) stake in the company, and reportedly threatened Nizhny's board chairman until he was forced to flee the Sverdlovsk region.[132]

Such widespread "de-privatizations" are not accounted for in the statistics touted by the Russia Federation.

E. Independent data are at odds with Russian privatization claims. Independent experts typically do not give Russia's privatization program credit for effecting a successful transfer of ownership and control from the government to the private sector. As one analyst concluded in 2000, "The state's formal presence in the economy remains formidable. Despite years of privatization, it is still the largest owner in Russia."[133]

Independent studies use a variety of quantitative indicators which confirm Russia's lack of progress in privatizing its economy. According to the EBRD, for example, Russia ranks well toward the bottom of more than 20 transition economies when measured by the value of shares sold per capita during the 1989-2000 period: about $100 per capita for Russia—less than Latvia and Slovenia—while for countries such as Poland, Lithuania, and the Slovak Republic this figure is in the $200 to $400 range, with the Czech Republic at $600 and Hungary over $1,200.[134] It is at least curious that the Czech Republic and Hungary privatized 6 to 12 times as much corporate value per capita than has Russia—which claims to have privatized 75 percent of its economy—when the per capita income of the two smaller countries is not even twice as much as Russia.[135]

F. Pervasive government control is exercised over nominally private entities. Neither the Russian government nor Russian respondents attempt to measure the degree of government *control*, as distinct from ownership, of Russian enterprises.[136] Instead, Russian respondents simply claim that property rights and entrepreneurship are respected by Russian law *de jure*, without either addressing the widespread conclusions of independent experts to the contrary or putting forth any evidence regarding the *de facto* effectiveness of such laws in preventing government control of nominally private enterprises.[137]

2000). "Nizhny Tagil Fights Bankruptcy Calls," *Metal Bulletin* (Apr. 30, 1999); "Yekaterinburg Opposes Nizhny Tagil Steel Bankruptcy," *Interfax Metals and Mining Report* (Apr. 2, 1999).

131 "Nizhny Tagil Steel Creditors Opt for Settlement," (undated) available at <http://www.europe-steel.com>; "Nizhny Tagil Seeks Agreement with Creditors" (Nov. 29, 1999).

132 "Row Brews Over Control of NTMK," *Metal Bulletin* (June 24, 1999).

133 Michael McFaul, "Russia's Stalled Economy," The World and I, (Mar. 1, 2000), cited in O. Lee Reed, *American Business Law Journal* (Spring 2001) n. 63.

134 *2001 Transition Report Update* at 23. Exh. 13.

135 CIA *World Factbook* 2001 (Russia: $7,700; C.R.: $12,900; Hungary: $11,200).

136 Government "control over the allocation resources and over the price and output decisions of enterprises," a separate Department of Commerce criterion, is discussed.

137 *Memorandum of the Russian Federation* at 17.

In practice when the government owns less than 50 percent of a company whose remaining shares are in private hands, the government often continues to control the company.[138] The ability of the government to retain such control despite having fewer than half of the outstanding shares is, in large part, the consequence of weak legal rights for smaller shareholders.[139] Moreover, the degree of government ownership in a company is also critical factor in determining the company's profit-orientation, and therefore value and market status. For example, a KPMG analysis of a major government-owned Russian insurance company concluded that if the government retained more than 75 percent of the company then the company would be worth $40 million. If, however, the government retained less -- between 50 and 75 percent -- the value of the overall company would be 25 percent higher, or $50 million.[140]

The continuation of government control over nominally "private" enterprises is strongest -- indeed, overwhelming -- at the regional and local level. As a detailed joint study by Raj M. Deai, a Georgetown University professor, and Itzhak Goldberg, a World Bank official specializing in Europe and Central Asian finance, concluded that:

> *regional governments have continued to exert a strong influence over actions of key enterprises, <u>regardless of whether they have been formally privatized</u>.... One recent study concludes that the devolution of economic control to the regions has preserved the sub-national administrative and hierarchical structures of the Soviet system, as well as the power and influence of those who manage them. Attempts by regional governments to protect unemployment by preventing firms from changing production lines or employment <u>levels constitute a significant distortion on enterprise operations</u>.*[141]

On a related note, in at least some of the major privatization transactions the government mandated that the purchaser commit additional investment capital to the enterprise.[142] Such arrangements are not consistent with commercial investment considerations -- why would a seller be concerned enough about the future of the sold enterprise to mandate future capital inflows? -- and result in the government foregoing revenue in order to channel additional, non-market capital into selected enterprises.

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138 For example, the Russian government currently has a minority stake in Gazprom but there is no debate about whether it is a government-controlled company. The government has announced plans to strengthen its role in Gazprom despite maintaining its minority status.

139 *See* Section V. infra.

140 "Sell-off begins for Rosgosstrakh state-owned insurer" *The Russia Journal* (Sept. 21, 2001), available at <http://www.russiajournal.com/weekly/article.shtml?ad=5198>.

141 Raj M. Desai and Itzhak Goldberg, *The Vicious Circles of Control: Regional Governments and Insiders in Privatized Russian Enterprises*, World Bank (Dec. 1999) at 10 (emphasis added).

142 <http://www.ipanet.net/documents/WorldBank/databases/plink/soceco/1russia.htm>.

G. Privatization is weakest in the key Russian industrial and trade sectors. For both ownership and control, the bulk of the true privatization has occurred in peripheral sectors of Russia's enormously concentrated economy, leaving government ownership and control largely intact in Russia's core industries.

In the Russian **banking** sector, the Central Bank owns 61 percent of Sberbank, the country's largest bank. Although nominally Russia has about 1,300 other banks, Sberbank's relationship with the Central Bank gives it an enormous role in the Russian economy. Russian savers -- who typically distrust Russian banks -- view Sberbank as having a "de facto deposit guarantee {which} makes it the obvious choice"[143] for deposits. In addition, the Central Bank reportedly uses its regulatory authority to boost Sberbank and other politically-connected banks at the expense of all other competitors. As *The Economist* summarized the problem:

> *Banks with good political connections obtain lucrative favours and connections. Outsiders risk penalties for missing a comma.... The central bank is a big operator in the industry it itself supervises, particularly through Sberbank.*[144]

Russia's second-largest bank, Vneshtorgbank,[145] is also state-owned. Industry analysts describe the bank as a "Soviet-era institution {which} continues to function more as a lender to government-linked entities than as a market-oriented bank...." according to the *Wall Street Journal.*[146]

In the **energy** sector, the government continues to own and control Gazprom, Russia's largest company, and UES, by some measures the second-largest. These companies are at the core of the Russian economy for two reasons. First, they supply the bulk of the country's energy needs, and are therefore main suppliers for most other Russian industries. Second, Gazprom accounts for a large portion of Russia's exports and therefore foreign-currency earnings, which translates into enormous economic power for the company and its government owners. As recently as May 31, 2001, President Putin declared that the state's role in Gazprom would be "enhanced" because the Russian economy relies on the company.[147] This contradicts Russian antidumping respondents' claim in a filing two months later that Gazprom was scheduled to be privatized.[148]

The Russian **transportation** sector, particularly the railroad network, is critical to the Russian economy because of the vast geography of the country coupled with the highly concentrated nature of manufacturing, which means that capital goods and raw materials often need to be sourced from a single location a long distance from the manufacturing site. Moreover, internal transport is a key cost input for Russia's traded goods (excepting oil and gas, which are also

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143 "Russian Bank Reform: Don't Bank on it," *Economist* (Oct. 21, 2001).

144 *Id.*

145 As measured by assets.

146 "Russia Will Sell 39% of state-owned insurer And Put Off Decision on Bank," *The Wall Street Journal Europe* (Oct. 26, 2001).

147 "State's Role in Gazprom Must be Enhanced -- Putin," *Moscow Interfax* (May 31, 2001).

148 *Memorandum of the Russian Federation* at 17. *See also* "Gov't State in Gazprom Unlikely to Shrink in Near Future -- Board Member," *Moscow Interfax* (May 31, 2001).

government-controlled). The Ministry of Railways controls this sector and there are no plans for privatization.

The Russian financial crisis largely put a halt to Russia's privatization program. As the EBRD summarized the situation, "Large-scale privatization in Russia has been suspended until a new, more detailed programme is approved."[149] Even before the financial crisis, the Russian government's willingness to sell large percentages of enterprises was declining, as shown in **Figure 3**, which is based on **Table A**.

[149] *2001 Transition Report Update* at 28. Exh. 13.

VII. Criterion 5: The extent of government control over the allocation of resources and over the price and output decisions of enterprises.

Summary of comments. Russian federal, regional and local governments regulate many prices directly through *price controls.* In addition, the federal government's antimonopoly authority has adopted the practice of setting prices itself through negotiation with the subject enterprises, resulting in *de facto* government regulation of hundreds, and perhaps thousands, of new prices each year. Finally, government-owned enterprises in large, key sectors of the Russian economy frequently set prices or collect payments based on policy objectives as opposed to profit-maximization objectives.

Discussion. A major factor underlying Russia's poor economic performance has been the distortion of prices and output throughout the Russian economy by federal, regional, and local governments. A World Bank research paper recently concluded that "Russia's economic problems have resulted from distorted {price} incentives in addition to weak institutions."[150]

A. Government price and output controls are pervasive in many sectors, including transportation, communications and energy.

The most transparent means by which the Russian governments at the federal, regional, and local levels control prices is through direct price regulation. The prices of nearly all goods and services in the energy, transportation, and communication fields are set by the government. In addition to predominant government ownership in these sectors, the federal government has identified hundreds of specific enterprises for which the government has direct authority to set prices because the enterprise is considered to be a "natural monopoly."[151] In 1999, there were 215 such entities in the transportation sector – including companies such as those that provide airport services – and 200 in the communications field, including TV advertising. Such enterprises must have at least one government official on the governing board, and the for each enterprise the "principal competence of the Board is to determine the prices (tariffs)" charged.[152]

The government's role in the pricing decisions for these hundreds of core Russian companies goes well beyond ensuring that they do not charge monopoly prices. Indeed, the

150 *Dismantling Russia's Nonpayments System: Creating Conditions for Growth*, World Bank Technical Paper No. 471 (June 2000) at x ("*Dismantling Russia's Nonpayments System*"). Exh. 17.

151 The term "natural monopoly" as used in the Russian context is somewhat different than the definition as conventionally employed in the West. Whereas a "natural monopoly" in the West describes a enterprise in a sector for which the technology (or production function) inherent in the production of the good favors a single supplier as the low-cost solution (usually due to a declining, rather than increasing, cost curve), in the Russian context the term "natural monopoly" is used far more broadly for any enterprise, almost always a former Soviet enterprise, that dominates a sector or geographic region (or both) to such a degree that its commercial and political power can prevent potential competitors from entering the sector or region. In other words, in the Russian context the term "natural monopoly" often applies to sectors, such as the automobile industry, wherein a Western economist would be unlikely to use the term because of the lack of an inherent, technological ("natural") barrier to entry for competitors.

152 Ministry Of The Russian Federation For Antimonopoly Policy And Support To Entrepreneurship, *Annual Report On Competition Policy Developments In The Russian Federation In 1999.* ("*MAP Annual Report 1999*"). Exh. 18. Unlike The United States, regional And local authorities have no separate *de jure* competition-policy authority.

stated goal of price-setting in these "natural monopolies" often relates to ensuring the sector remains subsidized and competitive with foreign enterprises, or that such macroeconomic goals -- such as low inflation[153] -- are achieved. As one 1999 government document acknowledged:

> *In course of accomplishment of the state tariff {price} policy in the field of railway transportation, the increase in efficiency of the Russian transport system functioning, aiming at securing competitiveness of Russian producers and supporting the strategic goods carriers, the governmental commission was created on improving the state tariff policy on federal railway transportation and transportation policy.*[154]

The problem of government interference in nominally private pricing decisions is even more widespread at the regional and local level. The World Bank recently concluded that "Regional governments, through their interaction with large regional enterprises and regulatory interference, play a role in hampering competition as well."[155] In its annual Deregulation Report, the Asia-Pacific Economic Cooperation (APEC) organization noted that Russian government price regulation is a significant problem.

> *It's clear that economic activity of Russian enterprises is not transparent and the state regulation of business activity is not in sufficient order. At the same time, forms and methods of their regulation are often in contradiction with the antimonopoly legislation. The activity of licensing, certifying, supervising and controlling bodies should be put in order. Numerous abuses and requisitions by these organizations in some cases hinder the development of business and investment. One of the way to improve market relations consists in creating the framework for developing the competitive market and preventing these bodies from {participating in} the process.*[156]

Typically, price regulation overlaps with the other two channels for government price and output control: the antimonopoly regime and the use of government enterprises to affect price and output levels.

B. The government controls prices under guise of "antimonopoly" policy.

In the early years of the Russian Federation, the federal government established an antimonopoly regime to enforce competition policy in an economic environment in which the large Soviet-era enterprises would dominate the Russian economy as private or quasi-private enterprises. Russian officials and experts typically refer to these large enterprises as "monopolies" or even "natural monopolies." The current government entity competent in this

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153 *MAP Annual Report 1999*, paragraph 38. Exh. 18.

154 *Id.* at paragraph 39 (emphasis added). Exh. 18.

155 World Bank Country Assistance Strategy: Russian Federation (Jan. 11, 2001) paras 34-35, available at <http://wwwwds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2001/02/02/000094946_01012505312027/Rendered/INDEX/multi_page.txt.>. ("*World Bank Country Assistance Strategy*").

156 APEC *Deregulation Report 2000*, available at <http://www.apecsec.org.sg/loadall.htm?http://www.apecsec.org.sg/deregulation/dereg2000.html.> (emphasis added).

area is the Ministry of Anti-Monopoly Policy and Support for Entrepreneurship ("MAP") which operates at the federal level and through 70 regional offices.[157]

Although the replacement of government-controlled production with an antimonopoly regime governing (nominally) private enterprises is, in the abstract, fundamental to the transition from a state-controlled economy to a market-oriented economy,[158] in the case of Russia the antimonopoly regime has, in practice, evolved into little more than a vehicle for economic regulation through price controls, rather than the means by which competition-policy goals are achieved through law enforcement of competition policies. MAP has been publicly criticized for "assuming too many powers" and seeking comprehensively to regulate pricing of a broad range of enterprises while "the direct functions of the ministry – anti-monopoly action and support of small business – are being forgotten."[159]

In particular, MAP's lack of resources and expertise -- its budget was less than $5 million in 1999[160] -- combined with the prevalence of large "dominant" enterprises in many regions and sectors, has led MAP officials to substitute *de facto* price-controls (often negotiated) for long-term structural solutions (such as the forced break-up of firms deemed to have market power) in a vast number of cases extending throughout the Russian economy. In 1999 alone, for example, MAP considered approximately 2,100 cases of suspected pricing abuse by large Russian firms, of which 1,026 cases were in fact deemed "violations."[161] In about 490 of these cases, the pricing abuse was settled by "mutual agreement" between MAP and the enterprise, with another 538 cases being challenged by MAP in court.[162]

MAP also substitutes agreements on pricing for action against structural dominance by large enterprises. Thus MAP officials will often challenge a propose merger that arguably would create a "dominant enterprise," but acquiesce if the new enterprises agrees to certain constraints on pricing. Once again, the vast number of such cases -- more than 3,500 in 1999 alone[163] – must be compared to MAP's limited expertise, personnel, and resources when considering the extent to which MAP's role in setting prices achieves the goal of allowing "market" prices to prevail in Russia.

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157 MAP's predecessor entity was the State Committee of Antimonopoly Policy. *MAP Annual Report 1999.* Exh. 18. Unlike The United States, regional and local authorities have no separate *de jure* competition-policy authority.

158 For example, *see* Department of Commerce discussion in *Poland NME Review*, in which the development of an antimonopoly regime was cited in support of the decision to declare Poland to be market-oriented.

159 "The Battle for the Economy," *Kompania* (May 15, 2000).

160 *MAP Annual Report 1999* at 15. Exh. 18.

161 *Id.* Exh. 18. Unlike The United States, regional and local authorities have no separate *de jure* competition-policy authority.

162 *Id.* Exh. 18.

163 MAP considered 3,561 proposed mergers or acquisitions in 1999, 3,490 of which (more than 98 percent) it considered sufficiently problematic to initiate legal procedures" against the proposed transaction, and in 3,028 cases a "decision {was} taken" within the same year. *Id.* Exh. 18.

Experts in the West note that these cases of prices set by "mutual agreement" have no sunset provision, and therefore the number of instances in which the MAP has negotiated the price set by firms is now in the thousands. Because most Russian economic activity is dominated by large enterprises, these thousands of pricing "cases" constitute a large share of the Russian economy. Moreover, MAP itself notes that the main sectors covered electricity and heat energy, gas, oil and petroleum, communication, railway transport, air transport and airports[164] – Russia's core sectors which produce a large portion of the inputs the rest of the Russian economy. [165]

In addition to the control of these nominally private enterprises, the degree of government influence over prices is also demonstrated by the fact that the MAP's regional offices in 1999 alone reviewed 2,234 "draft acts of executive bodies" (i.e., regional and local government laws and regulations) for possible pricing violations, nearly half of which were deemed to be problematic by the MAP.[166] This huge number of cases is evidence of both the enormous role that regional and local governments play in setting prices in their jurisdiction (at least 2,234 instances in a single year) and the omnipresent role that the understaffed MAP plays in deciding the eventual "market" price arising from these acts.

Independent observers confirm that the MAP is subject to significant political influence. For example the World Bank's third major structural-adjustment loan for Russia (1999) included development *goals* in the field of competition policy which included, among other things, the adoption of legislation to ensure that MAP is governed by its own board, makes regulatory decisions that are independent and rule-based, and is financially autonomous.[167]

C. Government enterprises provide massive input subsidies to Russian industry.

The Russian government controls the price of most energy inputs into the Russian manufacturing and service sectors through its ownership and control of the major energy suppliers, particularly RAO UES (mainly electricity) and Gazprom (natural gas). In addition to setting listed prices on a discriminatory basis, these government entities often provide enormous subsidies to energy users by simply not collecting payments on energy provided. In January 2001, the World Bank concluded that:

> *Although there has been a significant turn-around in the economy, there have been few underlying changes in the overall environment for private sector development.... Unfortunately, the bankruptcy legal regime needs further*

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164 *Id.* Exh. 18.

165 By contrast, in the year 2000 the U.S. Department of Justice undertook no more than a couple dozen consent decrees and out-of-court settlements in antitrust cases, which typically do not specify a government agreed-to price. Similarly, the Federal Trade Commission issued only 24 consent orders in 1998. *See* FTC Annual Report 1998. Similarly, the Federal Trade Administration issued only 24 consent orders in 1998. The much larger number of Russian cases in which a price is set by "mutual agreement" by the government cannot be interpreted as evidence of a strong antimonopoly authority enforcing market-based pricing: MAP simply does not have the expertise or resources to be gauging the actual "market price" in so many instances. Department of Justice press releases, Jan.-Dec. 2000.

166 *MAP Annual Report 1999*. Exh. 18.

167 *See, e.g.*, July 1999 Letter of Development Policy for the World Bank's Third Structural Adjustment Loan.

reform, and the continued implicit subsidization, through low energy prices and non- payments, of unrestructured large firms makes the playing field uneven. While clear progress has been made in raising cash collections for RAO UES, the national energy monopoly, to over 80 percent, and to over 90 percent for the Railways and pipeline system, Gazprom cash collections continue to lag behind without a clear plan for resolution. Key factors facilitating progress have been the real depreciation of the ruble compared to pre- crisis levels, and the erosion of domestic energy prices in real terms. The ability and willingness to continue enforcing high cash collections should one or both these factors change, remains to be seen.[168]

The consequences for the overall Russian economy of such subsidization is vast. In a June 2000 Technical Paper, World Bank officials identified implicit subsidies arising from the selected companies' non-payment for government-controlled energy as a major factor behind Russia's financial crisis as well as its continuing economic problems.

Nonpayments has been fiscally costly, has become a critical constraint to economic growth in Russia, and has had ambiguous welfare effects. It has also diluted the credibility of the key strategic reforms undertaken as part of Russia's transition to a market economy. As is clear from figure 1, nonpayments has been fiscally costly, raising public debt to levels that forced the macroeconomic crisis of August 1998. In retrospect, given the scale of subsidies implicit in nonpayments-estimated...at 4 percent of gross domestic product (GDP) per year from the energy monopolies alone-it is not surprising that the stabilization collapsed. Nonpayments has also prevented attainment of another key strategic goal: the resumption of growth.... {the problem of} nonpayments has destroyed the incentives for enterprises to restructure and use inputs and existing assets more efficiently. As {a result,} a new industrial organization has resulted, based on an alliance of interests between managers of viable and nonviable companies, who have had strong incentives to collude and partly siphon off the implicit subsidies. This has fueled corruption, asset stripping, and capital flight. At the same time, by distorting prices, nonpayments has prevented the new relative prices, which resulted from liberalization, from serving as clean signals for resource allocation. Growth gets stifled, as there is little incentive for efficient companies or new entrants to invest more and increase output in this climate. A key finding of this report is that the process of institutionalizing nonpayments has been incentive-driven. In other words, Russia's economic problems have resulted from distorted incentives in addition to weak institutions.[169]

168 *World Bank Country Assistance Strategy* paragraphs 34-35 (emphasis added).

169 *Dismantling Russia's Nonpayments System* at x. Exh. 17.

In the Russian steel sector a 1999 McKinsey study observed:

> *Many of the Small Other and a few of {Russia's} Medium Six {steel} plants are not viable and can not operate without outside help. This support is provided in the form of an implicit government subsidy delivered via barter deals with suppliers and customers who are forced by local government to deal with the plant. For example, <u>local government can provide cheap gas because it controls local gas distributors</u>. It can also initiate local projects (e.g. a medium size Russian city is now building a metro) where participants receive steel from the local plant in exchange for tax waivers.*[170]

[170] *Unlocking Economic Growth in Russia*, McKinley Global Institute (Oct. 1999).

VIII. Criterion 6: Such other factors as the administering authority considers appropriate.

Summary of comments. In addition to the five specific criteria set forth in the NME statute for assessing whether a subject country has become a market economy, Congress directs the Department to consider "such other factors" that it "considers appropriate."[171] The Department has considered a variety of "such other factors" in its recent determinations with respect to the transition of Slovakia, the Czech Republic, and Latvia to market economy status. In general, an application of these factors to Russia simply underscores how sharply differentiated its situation is from the countries which have been found to have successfully made the transition.

A. The judicial system, political freedoms and the rule of law are severely underdeveloped.

Summary of comments. A weak judicial system, the government's frequent disregard for constitutional and legal norms, and widespread corruption have combined to produce a pervasive failure of the rule of law and respect for property rights in Russia. A substantial proportion of all economic activity in Russia is conducted by organized criminal groups. To date, President Putin's reform efforts have made little progress.

Discussion. In recent NME-in-transition decisions, the Department has considered the relative development of a subject country's judicial system and the prevalence of the rule of law as factors relevant to determining successful transition to a market economy.[172] The Department cited Slovakia's recent elections, for example, as a sign that:

> *a growing number of people in Slovakia realize that political freedoms and the rule of law are critically important for achieving long term economic prosperity... The consequent strengthening of political freedoms and the rule of law in Slovakia can only serve to deepen and bolster the economic freedoms that necessarily underlie a market economy.*[173]

The Department noted that Latvia's judicial system "remains underdeveloped, as law court funding levels and inadequate training of many judges reduces the efficiently and credibility of the judicial system." However, it noted there are "signs that the system is improving," including growing bar membership, a system of state-provided public defenders, computerization of court records and a general upgrading of facilities of Latvian courts.[174] Such determinations indicate

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171 19 U.S.C. § 1677(18)(B)(vi) (1995).

172 The general acceptance of the rule of law is critical for determining whether a market economy exists in a subject country. As noted by legal experts, "{L}aw is a necessary foundation for the promotion of business because the rules of the state create the private market in the modern nation. These rules create the marketplace by establishing private property in the limited resources that are voluntarily exchanged through this system." O. Lee Reed, *Law, the Rule of Law, and Property: a foundation for the private market and business study*, 38 AM. BUS. L.J. 441, 451 (2001).

173 *Slovakia NME Review* at 13-14.

174 *Latvia NME Review* at 18-19.

that while a subject country's political and judicial systems need not be fully held to Western standards, clear signs of progress toward a functioning judicial system, political freedoms, and respect for the rule of law is expected. Russia fails to meet even this relaxed standard.

1. ***Failure of the rule of law in Russia.*** The state of lawlessness which characterizes much of Russia's economic activity and Russian society in general is viewed as one of the country's principal problems. Courts and the judiciary do not enjoy the respect of the citizenry or of other arms of the government, and, according to some sources, do little to deserve it.[175] One analyst recently observed that:

> *Unfortunately, Russia's elected leaders – from executive officials to members of parliament to local politicians – frequently ignore rulings by the courts. This runs counter to Russia's desire to create a rule-of-law state and indicates how far removed Russia is from the law.*[176]

A serious shortage of judges, as well as poor pay, inadequate courtrooms and low status in society, are seen as major structural problems with the Russian judicial system, further compounded by the inadequacies of the written law.[177] Jury trials are available in only 80 of the 89 Russian regions, and even in these regions, juries are limited to defendants on trial for the most serious crimes.[178] According to the Deputy President of the Russian Federation, Russian "{s}ociety regards the court as an instrument hostile to its interests." This sentiment is further aggravated by the fact that the Constitutional Court is the only court that publishes all decisions, and "other courts are categorically opposed to this openness."[179]

> *Until Russia develops a credible legal system that recognizes and protects property rights, especially in the real estate and agricultural-land markets,*

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175 In 2000 the Department of State criticized the Russian judicial system, among other things, for coercing confessions through extreme torture and generally failing to protect human rights guaranteed by the Russian Constitution and the Criminal Code. *See Russia Country Report on Human Rights Practices for 1999*, U.S. Department of State, Sec. 1(c), available at <http://www.state.gov/www/global/humanrights/1999hrpreport/russia.html>.

176 Damian S. Schaible, *Life in Russia's 'Closed City': Moscow's Movement Restrictions and the Rule of Law*, 76 N.Y.U. L. REV. 344, 369 (April 2001) ("*Schaible*"). Exh. 19. According to the Deputy President of the Constitutional Court of the Russian Federation, Tamara Morshchakova, there are many structural problems with the Russian judicial system. She even shared how a plaintiff, who was beaten up <u>in a courtroom</u> was denied compensation for resulting medical expenses since "a judge cannot be proceeded against for anything that has to do with his judicial activity." "Constitutional Court Justice Warns Against Judicial Reform Backsliding," *Moscow Ekspert* in Russian (Mar. 12, 2001) *translated in* FBIS (Mar. 22, 2001). Exh. 20.

177 "The weakness in the law manifested itself in vague, contradictory and inconsistent formulations... conflict between laws which had been centralized and the republics.... and the instability of unclear laws which change from day to day." Peter Naray "Russia and the World Trade Organization," *Palgrave* 2001 at 60. Exh. 21.

178 Shannan C. Krasnokutski, *Human Rights in Transition: the Success and Failure of Polish and Russian Criminal Justice Reform*, 33 CASE W. RES. J. INT'L L. 13, 56 (2001).

179 "Constitutional Court Justice Warns Against Judicial Reform Backsliding," *Moscow Ekspert* (Mar. 12, 2001). Exh. 20.

economic prosperity will be limited to the boom-and-bust cycles of world oil prices. Without a transparent government and clear rules, Western lending and optimistic public relations are not going to do the trick. Domestic capital flight will continue and foreign investors will not come.[180]

While Russia's written Constitution guarantees a panoply of individual rights, a general disregard for those guarantees pervades Russia's legal and political system. For example, the city of Moscow continues to enforce a restrictive registration regime similar to the propiska system despite constitutional guarantees of freedom of movement, federal statutory programs implementing that right and Constitutional Court rulings that such restrictions are unconstitutional.[181] Violators of this law are effectively turned into nonpersons in the eyes of local law: they are unable to vote, marry legally, send their children to school, receive public assistance and free medical available to all other residents, or even buy a gravesite.[182] Such disregard for basic Constitutional guarantees worsens outside of Moscow:

It's a sort of legal nihilism....The further from Moscow, the less attention they pay to the legal side of things. There is no understanding of a final court decision.[183]

The failure of the judiciary and a decreasing respect for the rule of law impacts all areas of Russian society and the economy, and exercises adverse influences on all of the factors considered in the six-part statutory NME test. For example, the failure to enforce existing labor laws results in the absence of free bargaining between workers and management, while dissatisfied workers only further lose faith in the legal system. The continued politicization of businesses perpetuates the failure of bankruptcy laws by providing incentives for managers to make non-viable businesses appear to be solvent.[184] Failure to enforce tax laws and punish those who underreport revenue and transaction values encourage barter transactions between businesses.[185]

Continued refusal to submit to the law and judicial decisions on the part of Russian leaders, in turn, will do further damage to the legitimacy of the legal system and the courts. Actions that flout federal law, such as those by Moscow's leaders, work to lessen the influence of future laws and court rulings, thereby hindering the growth of the legal consciousness needed in the country for the rule of law to take hold.[186]

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180 Ariel Cohen, "Can the Boom Last?" *Moscow Times* (Dec. 8, 2000).

181 *Schaible* at 344. Exh. 19.

182 *Id.* at 357. Exh. 19.

183 *Corporate Governance* at 1742. Exh. 12.

184 William P. Kratzke, *Russia's Intractable Economic Problems and the Next Step in Legal Reform: Bankruptcy and the De-politicization of Business*, 21 J. INTL. L. BUS. 1, 2 (2000).

185 An official survey of 201 key Russian enterprises estimated that barter, debt-swaps and other non-monetary deals accounted for 73% of transactions in 1996 and 1997. *See id.* at 20.

186 *Schaible* at 371. Exh. 19.

2. ***The criminalization of the Russian economy.*** The failure to establish a viable legal system enforced by a judiciary that enjoys the respect of the Russian people has facilitated a veritable explosion of organized criminal activity throughout Russia since the breakup of the Soviet Union. Organized crime has "evolved into a pillar of the Russian economy," and is "omnipresent in many industries." Crime syndicates have "penetrated so deeply into many corporations that it is almost impossible to differentiate them from entrepreneurs." The government and police organs have "shown neither the ability nor the will to tackle this critical problem," and it is claimed that "in many cases local governments and officials act more as an arm of this criminal system than of the government."[187]

> *Organized crime and corrupt government officials control over 40 percent of the Russian economy, including approximately two-thirds of all commercial institutions, 35,000 businesses, 400 banks, as many as 47 stock exchanges, and 1500 government-owned enterprises. It was also revealed that 35-80 percent of the shares in different financial institutions were controlled by Russian criminal organizations. Most commercial undertakings have to pay 'protection money,' ranging between 10 to 50 percent of turnover to stay in business.*[188]

The mid-1990s decision to organize the Russian economy around financial industrial groups ("FIGs"), along the lines of South Korea's chaebol, fostered the blossoming of wholesale corruption and organized criminal activity. In 1995, Russian banks were allowed to buy stakes in leading companies at prices far below market value, creating a windfall for well-connected Russian entrepreneurs positioned to acquire large ownership stakes; it is widely believed that corrupt government officials rigged the auctions. The sales created a coterie of "oligarchs" in Russia, who have subsequently been able to amass enormous personal wealth, economic power and political clout:

> *The loan-for-shares saga also undermined efforts to encourage a culture of fair, free market management and corporate governance practices in Russia by seeming to endorse a business culture with limited respect for the rule of law and shareholders' rights. A business tradition of corruption, if not criminality, developed in its place. Indeed, in some circles the oligarchs are routinely characterized as "kleptocrats," who have produced nothing, invented nothing, and enriched no one but themselves through back-room deals.*[189]

Western experts have pointed to the recent decline in the activities of criminal gangs as an indication that organized crime is less of a problem than it once was, but

> *Although some criminal gangs have been liquidated in turf wars, and others sidelined or eliminated by the police, most have simply adapted themselves to the*

187 "Editorial. A culture of Crime," *Russia Journal Online* (Oct. 21, 2000), available at <http://www.russiajournal.com.>.

188 Peter Naray "Russia and the World Trade Organization," *Palgrave* (2001) at 63. Exh. 21.

189 Corporate Governance Issues in the Russian Federation -- What Investors Should Know," *Standard & Poor's* (Nov. 2000), available at: <http://www.standardandpoors.com> ("*Standard & Poor's*"). Exh. 22.

new economy of the 21st century – undertaking the necessary corporate 'restructuring.'[190]

3. ***The stagnation of reform efforts.*** Many Russian leaders have sought reforms which would reduce the power of organized crime and establish a functioning legal system, but their efforts have been frustrated. During the Yeltsin era:

> *market reformers held key governmental positions. However, attempts at reform were frustrated by the difficult economic environment, the dominance in parliament (Duma) by communist and right-wing extremist groups opposed to market reforms, and the entrenched interests of the newly created wealthy elite.*[191]

The election of Vladimir Putin provided Russia with a real opportunity to pursue structural reforms. At the beginning of his second year in office, President Putin took steps to shake up government offices and reduce the power of the oligarchs. Unprecedented cooperation between the Kremlin and Duma led to the passage or consideration of tax reform, a land code, judicial reform, a money-laundering bill, and pension reform, among other pieces of legislation. However, Putin's reform agenda is opposed by many powerful groups, and "Putin's ability to combat entrenched interests and undertake genuine economic reform is far more limited than has generally been supposed."[192]

B. The Russian banking system is unsound and subject to manipulation.

Summary of comments. Russia's banking system is financially unsound and does not play a significant role in intermediation between savings and investment in the Russian economy. The Central Bank of Russia, heavily staffed with Soviet-era holdovers, has served as a source of preferential loans for favored industries; the bank has been racked with scandals and its bungling is blamed for some of the principal macroeconomic disasters that have engulfed the Russian economy since the Soviet breakup. In general, Russian banks are undercapitalized, often owned by oligarchs and enterprises which use them as their own private sources of funds, and are frequently involved in money-laundering and other criminal activities.

Discussion. A factor considered by the Department in a number of recent affirmative determinations of transition to a market economy has been the soundness and solvency of the banking system. The Department noted with approval that in Latvia,

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190 "Editorial. A culture of Crime," *Russia Journal Online* (Oct. 21, 2000).

191 *Standard & Poor's*. Exh. 22.

192 "FMA: 'Black Hole' in Russian Economy Fended Off, but Real Reforms Remain Elusive," *FBIS Media Analysis* (Apr. 24, 2001): Even if Putin is succeeding in installing a team of reformers who are loyal only to him, the enormous riches that Russia's economy can still offer, combined with the timeless temptations of power, leave it far from clear that the 'new guard,' once installed, will prove any more selfless or patriotic than their 'old guard' predecessors in the oligarchy." "Putin Replaces 'Old Guard' with FSB," *FBIS Media Analysis* (June 25, 2001).

Commercial banks are solvent, set their own interest rates, and invest their assets seeking the greatest risk-adjusted return. The central bank sets monetary and exchange rate policies independent of government influence or control. . . .[193]

The Department noted in its Slovakia and Czech Republic determinations that the banking sector in both countries suffered from bad debts and weak corporate governance, which were "hindering restructuring and efficient resource allocation and use," but commented that "these problems are certainly not unique to transition economies."[194] With respect to Slovakia, the Department commented that the bad-debt problem was "of manageable proportions."[195] In the Czech Republic, government recapitalizations of some banks were seen not as "policy loans" by the government to facilitate soft loans to industry on an administered basis, but "steps that are enabling the banks to assume fully the role they must assume to promote growth and the efficient use of capital resources in the Czech economy."[196] The situation in Russia is radically different than in any of the above countries, including those cited for weaknesses in the banking sector.

1. ***The weakness of the Central Bank.*** The Central Bank of the Russian Federation ("CBR") was founded on July 13, 1990. After a period of coexistence with the State Bank of the USSR ("Gosbank"), the CBR took over the institutions of the Soviet Bank when the latter officially disbanded on December 20, 1991.[197] Nonetheless, while the name of the institution and its ostensible mandate has changed, the CBR suffers from many of the inadequacies and infirmities of the pre-reform Gosbank. The manner in which the Central Bank operates and the structure within which it operates are more characteristic of the old Soviet system than of a market economy.

Many, if not most, of the CBR's employees are holdovers from the old Gosbank, with little or no experience in market-based central banking.[198] As Boris Fedorov (Russia's Finance Minister at the time) remarked in 1993, "the problem with the Central Bank is that there are practically no central bankers over there."[199] The skills that central bankers had developed in Soviet times – primarily shuffling papers and keeping accounting books in fulfillment of orders from above – differ dramatically from the skills necessary to function in a market-oriented

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193 *Latvia NME Review* at 1.

194 *Slovakia NME Review* at 15; *Czech Republic NME Review* at 16.

195 *Slovakia NME Review* at 15.

196 *Czech Republic NME Review* at 17.

197 Anthony Weir, *A Comparative Look at the Role of the Central Banks of Russia and Brazil in the 1999-99 Currency Crises* available at <http://home.austin.rr.com/anthonywier/Russia_and_Brazil.htm>.

198 The CBR is governed by an eight-person Board of Directors, one of whom is selected Chairman. The members of the Board are nominated by the President of the Russian Federation and are appointed by the State Duma of the Federal Assembly for four year terms. The Chairman also serves for a four-year term, and is nominated and appointed by the same process. In 1997, almost one-third of the CBR's employees had worked directly for the pre-reform Gosbank. Juliet Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (Cornell University Press, 2000) at 78 ("*A Fistful of Rubles*").

199 *Id.*, Chapter 3 at 64.

central bank.[200] The CRB has been slow to close troubled banks and tighten banking regulations.[201] While laws exist on the books that would allow the Central Bank to reform Russia's troubled banking sector, few of those laws are actively administered. As the CEO of a prominent Russian bank stated: "The Central Bank already has enormous potential to regulate the sector . . . but it doesn't use it."[202]

Perhaps the most troubling aspect of the CRB's administration of Russia's monetary policy has been the recurrence of corruption and malfeasance on the part of senior officials. There have been several spectacular scandals involving CRB officials over the past several years, including the FIMACO affair[203] and the SBS-Agro scandal.[204] The CBR has also worked behind the scenes to assist commercial banks to which it has ties.[205]

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200 *Id.* at 78.

201 Anthony Weier, *A Comparative Look at the Role of the Central Banks of Russia and Brazil in the 1999 Currency Crises* (Nov. 11, 1999) at 12.

202 The Central Bank has a financial stake in more than 20 commercial banks in Russia and abroad, including a 63 percent stake in Russia's dominant savings bank, Sberbank - which was the main beneficiary of the 1998 bank wipeout. "Commentary: Don't bank on Russian Bank Reform," *Business Week Online* (July 2, 2001).

203 In February 1999, Russian prosecutor general Yurii Skuratov revealed that over a six-year period the Russian Central Bank had secretly funneled more than $50 billion of Russia's hard currency reserves – including funds received as part of Russia's first standby agreements with the IMF – through a tiny offshore bank called FIMACO (Financial Management Company, Ltd.). In addition, it was revealed that during the late 1990s the CBR had used FIMACO to invest heavily in both Russian treasury bills ("GKO") and other Russian securities. Far from being chagrined about the FIMACO affair, the leadership of the CBR expressed irritation that the affair now had to end. As CBR deputy director Sergei Aleksashenko lamented, FIMACO "was an essential measure to protect the economic safety of the country - and now that mechanism is ruined." *A Fistful of Rubles* at 64-65.

204 In 1998, in the wake of the Russian default crisis, the government instructed the CRB to make loans to agro-industrial banks under guarantees provided by regional authorities. The CRB identified SBS-Agro as a major recipient of such loans, notwithstanding the fact that it was widely recognized that SBS-Agro was bankrupt at the time. A 5 billion ruble credit line was provided to the bank, ostensibly to help provide loans to farmers, and the regional governors provided loan guarantees to the CRB. However, all aspects of the credit line agreement between the CRB and SBS-Agro were declared strictly classified (i.e., a "commercial secret"), so the regional governors had no real idea what they were receiving in return for their guarantees. In reality, the credit line served only to rescue SBS-Agro from almost certain insolvency, with only a small fraction of the credit line ever reaching the regions at which it was ostensibly targeted. The majority of the monies received by SBS-Agro rapidly returned to Moscow, to prop up the bank and allow government agencies to remain serviced by SBS-Agro. In late October 2001, Deputy Chief Alexsandr Alekseyev of the CRB's Main Territorial Administration for Moscow was indicted for "exceeding the authority of his office by extending credit to SBS-Agro bank." It is widely recognized, however, that Mr. Alekseyev was simply a "fallguy" for officials much nearer the top of the CRB. As one banking community source noted, "{I}t is obvious that amounts of that size are handled not by the deputy chief, ore even the chief, of the Central bank main Administration for Moscow, but by the top officials of the Central Bank." "Central Bank's Alekseyev Indicted in SBS-Agro Loan Case," Moscow Izvestiya in Russian (Oct. 25, 2001) *translated in* FBIS (Oct. 25, 2001); "Central Bank Official Blamed for SBS-Agro Loan Default Merely a Scapegoat," *Moscow Moskoovskiy Komsomolets* (Oct. 31, 2001).

205 For example, the CBR owned 78.9 percent of Eurobank, which in turn owned 100 percent of the Moscow-based Evrofinans bank (a mid-sized bank). Evrofinans was awarded one of the first licenses to work with nonresident investors and became a primary dealer on the GKO market, accounting for over 40 percent of nonresident GKO activities in 1996. The Central Bank has a financial stake in more than 20 commercial

2. ***The banking sector is in disarray.*** The Russian banking sector is characterized by a lack of international standards of accountability, capital requirements, and enforcement abilities. The banking sector does not play a significant role in intermediation of funds between savings and investment, as is necessary to facilitate the normal function of banks in a market economy. As of mid-2001, reform in the banking sector "remains one of the weakest elements in the overall reform process," according to the OECD.[206]

Government-owned banks account for over 35 percent of total capital in Russia's banking sector.[207] The largest of the Government banks, Sberbank, alone accounts for 25 percent of total banking sector assets.[208] Sberbank, which also owns about half of all bank branch offices in the country, holds over 75 percent of household deposits in the country.[209] According to the OECD, without structural reform reversing this imbalance, private banks will "have little prospect of long term survival" and will be crowded-out by state-owned banks.[210] Yet, by mid-2001, the OECD observed, "the dominant role of state banks has further increased."[211]

In October, 2001, the Managing Director of the International Monetary Fund stated that the Russian banking sector has too many banks, "most of which do not have sufficient capital."[212] Only about 7 percent of banks have a capitalization of over $10.5 million, and over 50 percent of banks have a capitalization under $1 million.[213] Despite the passage of numerous laws intended to solve the problem of widespread undercapitalization, "little progress has been made to date, partly because the court system proved a formidable obstacle to rapid action."[214]

The Russian banking sector does not yet operate under "internationally accepted accounting standards."[215] Reflecting that fact, Russian banks continue to engage in "fraudulent transactions" in the foreign exchange market in order to assist clients in circumventing exchange controls intended to reduce capital flight.[216]

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banks in Russia and abroad, including a 63 percent stake in Russia's dominant savings bank, Sberbank - which was the main beneficiary of the 1998 bank collapse. *A Fistful of Rubles*, Chapter 3 at 64 n.1.

206 *2001 Transition Report Update* at 84. Exh. 13.

207 *Investment Environment in the Russian Federation* at 161. Exh. 5.

208 *Id.* Exh. 5.

209 *Id.* Exh. 5.

210 *Id.* at 36. Exh. 5.

211 *2001 Transition Report Update* at 84. Exh. 13.

212 "Russia: IMF Official Comments on Need for Russian Banking Reform," *Moscow Interfax* in English (Oct. 11, 2001) *reported in* FBIS (Oct. 11, 2001).

213 *Investment Environment in the Russian Federation* at 161, 162. Exh. 5.

214 *Id.* at 165. Exh. 5.

215 Establishment of mandatory internal risk management controls and adoption of rules for provisioning non-performing loans have not yet been accomplished. Planned "upgrading of accountability and compliance" in the sector, stalled by the 1998 financial crisis, had still not regained significant momentum by the end of 2000. *Id.* Exh. 5.

216 *Id.* at 63. Exh. 5.

Concealment of real bank ownership and suspect lending practices reduce the intermediation role banks typically play in a market economy country. Because ownership of banks is difficult to determine – due to the fact that many banks conceal their real shareholders – banks which often do not bear such risks on loans to formal shareholders in fact do carry high credit risks on loans to their underlying, real, owners.[217] As a result, 45 percent of the credit supplied by the banking sector is supplied to associated borrowers.[218] Combined with the fact that total resources held by the sector are low (see below), such practices often make access to bank credit available only to the owners of the banks, with the role of banks thus largely reduced to that of acting as treasuries for the enterprises or oligarchs which own them.

The intermediation function exercised by banks in a market economy, consisting of capital mobilization and resource allocation based on expected returns, is not present in the Russian economy. Total registered capital at the start of 2001 amounted to a mere 3.7 percent of year 2000 GDP, or under $8 billion.[219] Of total fixed capital formation in the economy, the banking sector financed just 4 percent in 1999.[220] Indeed, the State (budgetary) sector share of fixed capital formation financing was over four times as high as the banking sector share, while internal resources of enterprises accounted for 53 percent of financing.[221] This situation is even more pronounced in the financing of working capital, where the banking sector's role is "insignificant."[222]

Massive Capital flight symptomatic of an ailing banking system.[223] Reflecting in part the aforementioned factors, Russia and its banking system have experienced massive and unabated capital flight completely out of line with that in other transition economies. The IMF has pronounced that Russia "stands in sharp contrast to that of the more successful transition economies" with respect to capital flight.[224] IMF estimates, universally acknowledged to be

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217 "Insider" Crediting By Russian Banks Examined, *Moscow Ekspert* in Russian (Oct. 22, 2001) *translated in* FBIS (Oct. 23, 2001).

218 *Id.*

219 *Investment Environment in the Russian Federation* at 160. Exh. 5.

220 *Id.* Exh. 5.

221 *Id.* Exh. 5.

222 *Id.* Exh. 5.

223 Capital flight is usually distinguished from less disruptive capital *flows* insofar as it is defined as "excessive" capital outflows beyond those normally part of an international portfolio diversification strategy. *Capital Flight from Russia*, Prakash Loungani and Paolo Mauro, IMF Policy Discussion Paper, PDP/00/6 (June 2000) at 3-4 ("*Capital Flight from Russia*"). Exh. 23.

224 The IMF has reiterated this refrain, that Russia compares unfavorably with other transition economies with respect to capital flight in a number of papers: Russia "seems to be a special case among transition economies" and "stands out" among transition economies with respect to capital flight. *Capital Flight from Russia* at 6-7, Exh. 23.; and *The Transition Economies after Ten Years,* Stanley Fischer and Ratna Sahay, IMF Working Paper, WP/00/30 at 13 ("*The Transition Economies after Ten Years*"). Exh. 24. Other than Sub-Saharan Africa, Russia is the only country to which the IMF has devoted an entire analytical paper exclusively to the issue of capital flight.

conservative, put capital flight at $20 billion a year on average since 1994 in Russia.[225] A systematic comparison of cumulative and annual net capital flows to other former Soviet countries, Baltic countries, and particularly Central and Eastern European countries, demonstrates that "Russia is the only country that on a net basis exported capital throughout the transition period."[226] According to the IMF, capital flight continues unabated in Russia in the post-crisis period:

> *Several years into its transition to a market economy, Russia is still experiencing massive capital flight.*[227]

Capital flight is viewed by economists as a negative indicator in the transition to a market economy.[228] Moreover in the case of Russia, there is a general consensus that the component of capital flight originating from truly criminal activities stands out among transition economies. According to the IMF, capital flight may "reflect and facilitate illegal activities, and there is a widespread perception that this is particularly relevant in the case of Russia."[229] Whatever the mix of legal versus illegal capital outflows in Russia, excessive capital flight per se is considered a stumbling block in the transition to a market economy.

Furthermore, on a forward looking basis, Russia's specific efforts to stem capital flight (capital controls) are viewed by the IMF as likely ineffective in the medium-term and as potentially introducing further distortions into its economy. The IMF predicts that these measures will involve "costly distortions" – such as even more corruption, reduced economic efficiency, and distorted resource allocation.[230] Moreover, the IMF has asserted that factors contributing to capital flight cannot be rectified in less than a year, and that in the best case scenarios, more "successful transition economies" have managed to turn capital flight around

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225 *Capital Flight from Russia* at 4. Exh. 23. Some Russian government estimates are much higher. "Russian Robber Barons Stash Billions Off-Shore," *Insight on the News* (Oct. 19, 1998). Exh. 25; and "Official Estimates {Illegal} Capital Flight at $10-$15 Million Annually," *Moscow ITAR-TASS* in English (Dec. 20, 2000) *reported in* FBIS (Dec. 20, 2000). Exh. 26.

226 *The Transition Economies after Ten Years* at 13, 31-32. Exh. 24.

227 *Capital Flight from Russia* at 2. Exh. 23. The US-Russia Business Council, a private sector agency whose incentives to cast a positive light on the investment climate in Russia are strong, corroborated this IMF assessment in an even more recent study published in September 2001: "capital flight continues, although estimates of its scale vary greatly." "Russian Economic Survey," *US-Russia Business Council* (Sept. 2001) at 20, available at <http://www.usrbc.org> ("*Russia Economic Survey*"). Exh. 27.

228 Capital flight is one of the factors considered in *The Transition Economies after Ten Years* at 13, 31-32. Exh. 24. This paper considers capital flows among a number of factors in its assessment of the progress of economies in transition to market economy status. Capital flight can be comprised of funds earned through honest activities that are only illegal in that they breach capital controls or evade taxes; or they may be fully legal, but caused by weak political and economic institutions, such as macroeconomic instability, irrational tax rates, a weak banking system, widespread corruption, undefined property rights, etc. There is a strong negative correlation between capital flight and FDI, for example. Whatever the mix of legal versus illegal capital outflows in Russia, excessive capital flight per se is considered a stumbling block in the transition to a market economy.

229 *Capital Flight from Russia* at 2. Exh. 23.

230 *Id.* at 13-15. Exh. 23.

only after a few years. This means that whatever the outcome of Russia's efforts with respect to capital flight, their efficacy cannot be assessed for several years to come. As a result, because of the sheer size of capital flight in Russia, the time it takes to eradicate its underlying causes, and the specific capital controls approach Russia has taken to try to stem it, capital flight is expected to continue to undermine Russia's efforts in its transition toward a market economy for the foreseeable future.

C. Russia lacks a well-functioning system of bankruptcy.

Summary of comments. Russia's bankruptcy regime does not provide a system of orderly and rational market exit for failed firms. The bankruptcy process has deteriorated into an instrument that enables local governments and criminal groups to control, exploit, and in some cases plunder insolvent enterprises, many of which would have been liquidated long ago in a rational system.

Discussion. In its previous reviews of market economy status, the DOC concluded that the strengthening of bankruptcy laws is an important element in the transition to a market economy.[231]

> *The passage of a well-functioning bankruptcy law is an important component of the transition to a market economy. It should protect creditors, impose financial discipline on managers, induce restructuring, and free assets from inefficient use.*[232]

The chief of Russia's Federal Financial Recovery and Bankruptcy Service (FFRBS) commented recently that "{T}he current bankruptcy law is the worst law ever passed in all of Russia's history."[233] The current law, enacted in 1998, replaced Russia's first bankruptcy law, passed in 1992, which proved "completely ineffective" -- between 1992-1998, very few companies went bankrupt.[234] The sharp increase in bankruptcy filings since 1998 is sometimes cited as an indication that the new law is working and managers are now facing real market-driven constraints. However, what has actually resulted is:

> *a paradoxical situation . . . enterprises which are sufficiently robust are becoming increasingly subject to bankruptcy proceedings . . . while enterprises which are beyond hope are escaping the procedure . . . .*[235]

A number of solvent enterprises have declared bankruptcy under the new law in order to escape various obligations. The FFRBS chief acknowledges that "the law in its present form has

231 *Latvia NME Review* at 17; *Czech Republic NME Review* at 4; *Slovakia NME Review* at 4.

232 Mogiliansky, Sonin, and Zhuravskaya, "Capture of Bankruptcy: Theory and Evidence from Russia," (Sept. 27, 2000), available at <http://www.columbia.edu/cu/sipa/REGIONAL/H1/lsz.pdf>. ("*Capture of Bankruptcy*") Exh. 28.

233 "Russian Federal Bankruptcy Service Chief Trefilova on Bankruptcy Law," *Vek* (Oct. 26, 2001).

234 *Capture of Bankruptcy*. Exh. 28.

235 "The Investment Climate in Russia," *Expert Institute,* Ernst & Young (2000), available at <http://www.ernst&young.com> ("*Ernst & Young*"). Exh. 29.

been turned into an instrument of illegal enrichment," and believes that the level of criminalization in bankruptcy proceedings is "extremely high."[236] According to Russian Prime Minister Kasyanov, the current law "makes it possible to avoid payment of taxes and to use bankruptcy proceedings as a means for re-division of property."[237] The "inadequate regulation of the initiation of bankruptcy proceedings, and the bankruptcy procedure itself, also create serious threats to investor rights," and are major barriers to foreign investment.[238]

Conversely, according to Economics Minister German Gref, of the 25-40 percent of Russian enterprises that really are insolvent, very few have been shut down or restructured – in effect, nonviable enterprises are still not exiting the market.[239] One reason is that local judges – dependent on regional authorities – are given the discretion to reject liquidation recommendations. As a result, "in the Russian context of weak law enforcement, discretionary powers granted to judges are abused, and the law does not achieve its goals."[240] Another major flaw in the law is that it gives regional authorities "a greater say in the repartition of property and assets."[241] Regional governments are reluctant to send firms into bankruptcy not only because they come low down on the creditors' list, but more importantly:

> *bankruptcy proceedings have been delayed or annulled because of the political risk of closing hundreds, perhaps thousands of enterprises -- without an adequate social safety net in place -- in what are often one-factory towns.*[242]

According to one study of Russia's bankruptcy law:

> *A supposedly balanced law under the absence of the rule of law has transformed into a mechanism that allows regional governors in alliance with incumbent managers of the large regional enterprises to leave other claim-holders unsatisfied . . . outside creditors, even the major ones, such as large Moscow*

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236 "Russian Federal Bankruptcy Service Chief Trefilova on Bankruptcy Law," *Vek* (Oct. 26, 2001).

237 "Government Session Reviews Amendments to Bankruptcy Law, Customs Code," *Kommersant* (Nov. 14, 2001).

238 *Ernst & Young*. Exh. 29. In the bankruptcy of Tokobank, one of its largest shareholders -- the EBRD, was unable to secure recognition of its claims "due to the non-transparency of the bankruptcy proceedings and loopholes in the legislation."

239 *Russian Economic Survey*. Exh. 27.

240 *Capture of Bankruptcy*. Exh. 28.

241 "Revised Bankruptcy Law Opens Floodgates," *The Russia Journal* (May 17, 1999).

242 *Russian Economic Survey*. Exh. 27. There are numerous examples of regional authorities granting local firms protection from bankruptcy: In Siberia, the regional authorities stepped in to prevent the bankruptcy of Kuznetsk and ZapSib steel enterprises, *See Global Steel Trade* at 41. Exh. 1; the Sverdlovsk governor vowed to prevent the bankruptcy Uralvagonzavod plant, which employs 25,000 workers and Chelyabinsk governor said he would grant 200 of the oblast's leading firms political protection from bankruptcy. *See Russian Economic Survey*. Exh. 27; and local authorities postponed turning over the West-Siberian Metallurgical Plant, *See* "Revised Bankruptcy Law Opens Floodgates," *The Russia Journal* (May 17, 1999).

banks and the federal government, have no effective legal mechanism for collecting their claims.[243]

Although the Russian government is discussing amendments to the 1998 bankruptcy law, at present, according to the EBRD "a credible bankruptcy threat still does not exist."[244]

D. Russia lacks an efficient, equitable, and transparent system of taxation.

Summary of comments. Russia's tax system is arbitrary, nontransparent, and unevenly administered. Distortions in the tax system are a principal factor contributing to the proliferation of barter in the Russian economy and the explosive growth of the "underground" economy. Reform efforts are unlikely to alter this dynamic even if currently-pending reform legislation is enacted.

Discussion. In its most recent NME-in-transition determination, involving Latvia, the Department emphasized the importance of an "efficient equitable and transparent" system of taxation to an affirmative finding. It explained its reasoning as follows:

> *The development of an efficient, equitable and transparent tax-collection system is critically important in helping to ensure that the government remains sufficiently divorced from enterprise management, enterprise budget constraints remain sufficiently hard, investment returns can be reasonably anticipated, and social welfare programs that help to ease the pain of economic transitions can be funded. Where taxes are not collected or deferred, or where taxes are imposed on an arbitrary, ad hoc basis and in an opaque manner, compromising government-enterprise relationships, corporate governance and budget constraints can become weak and the rule of law suffers, generating economic lassitude and instability*[245]

A consensus exists in recent academic and economic literature that Russia's tax system is not only not "efficient, equitable and transparent," but has created perverse incentives that foster gross economic distortions – such as a hyperactive informal economy and the proliferation of non-cash or barter transactions. Typical comments:

- *"The existence of a burdensome, unfair, and uncertain tax system has been mentioned almost unanimously, by Russian and foreign observers alike, as one of the main causes for Russia's lack of investment, stagnant growth, and overall lackluster economic performance during the transition to a market economy."*[246]

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243 *Capture of Bankruptcy*. Exh. 28.

244 *Global Steel Trade* at 41. Exh. 1.

245 *Latvia NME Review* at 19-20. The Department did not examine the taxation systems in the subject countries in its Slovakia and Czech Republic determinations.

246 Jorge Martinez Vazquez and Sally Wallace, *The Ups and Downs of Comprehensive Tax Reform*, 9 TAX NOTES INTERNATIONAL 2261 (Dec. 13, 1999) ("*Vazquez & Wallace*"). Exh. 30.

- *"Various aspects of the {tax} system . . . created perverse incentives. These incentives, in our view, help to explain the falling federal revenues, growing tax evasion, stagnant economic growth, and widespread unofficial economic activity in most regions of the country."*[247]

- *"The importance of revenue mobilization has been highlighted by the August 1998 economic crisis in Russia. The crisis had several causes, but a key one was the inadequacy of federal government tax policies in achieving a sustainable improvement in revenue mobilization."*[248]

- *"Under the previous regime, taxes completely lacked transparency. . . . That tax system created a taxpayer culture of mistrust of government and of noncompliance that endures today . . . . The broad perception among taxpayers of corruption of government officials continues to contribute to an unwillingness to pay taxes and undermines the basic fabric of society."*[249]

Heavy tax burdens, arbitrarily and unfairly assessed against the business community, are widely blamed for driving the official economy underground – such taxes "were one of the triggers for the exodus of firms into the unofficial economy."[250] Because local, regional, and federal governments have been able to impose additional taxes or raise rates on the same tax base, the effective tax burden on individual businesses has usually been higher – sometimes much higher – than the nominal tax rates they face, leading them to seek revenues in the unofficial economy.[251] "{F}ull compliance with the combined tax burden," according to the U.S. Department of State, "would have driven most enterprises out of business."[252] As a result, "indebtedness on taxes is the main factor in the negative motivation of firms in the real sector."[253]

Recent economic literature from analysts at the IMF, the U.S. Department of Commerce, and academia emphasizes the link between Russia's tax system and the creation and maintenance of the barter and non-cash economy.[254] "Tax evasion--especially the evasion of *federal* taxes--

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247 Andrei Shleifer and Daniel Treisman, *Without a Map: Political Tactics and Economic Reform in Russia* at 119 (MIT Press: 2000) ("*Without a Map*"). Exh. 31.

248 *Tax Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union*, IMF Occasional Paper 182 on Issues in Transition (1999) at 2. Exh. 32.

249 *Vazquez and Wallace* at 2270, 2271. Exh. 30.

250 *Without a Map* at 95-96. Exh. 31.

251 *Id.* at 119-123. Exh. 31.

252 *FY 2001 Country Commercial Guide* at 24. Exh. 10.

253 "The Russian Economy: Conditions for Survival and Preconditions for Development," *Problems of Economic Transition: Perspectives and Prognosis on Russia's Future* (April 2000) at 70. Exh. 33.; *Without a Map* at 95. Exh. 31.

254 *Russian Federation: Selected Issues* at 74. Exh. 11; "Evaluation of Taxes and Revenues from the Energy Sector in the Baltics, Russia, and Other Former Soviet Union Countries," Dale F. Gray, IMF Working Paper WP/98/34 (Mar. 1998) at 56. Exh. 34; the DOC stated, "While these liquidity problems may have encouraged barter, its continued use could not have been maintained without the government's tolerance

was a major reason for the spread of barter among profitable enterprises."[255] The proliferation of the non-cash economy occurred because regional and local budgets could accept payments in kind more easily than the federal budget and willfully abetted firms' evasion of federal taxes by allowing them to pay their local taxes in kind and to keep the federal government share.[256] Even at the federal level, a massive industry-wide "tax subsidy" through non-cash transactions estimated at 15 to 25 percent of GDP has allowed enterprises to accumulate taxes without paying them.[257]

In the steel industry manipulation of taxation on both sides has been rampant. One industry participant observed: "{I}n reality. . . the tax system is full of loopholes, corruption and confusion.. . . Each of the mills has its own arrangement with the authorities."[258] Among other things, such tax "help" enabled the least efficient elements of the Russian industry to survive and continue producing steel. The Department of Commerce observed in its Global Steel Trade 2000 report that:

> *The fact that tax arrears grew while production increased sheds light on the unique economic environment in which Russian steel companies operated. In the words of one analyst, 'the state's systematic failure to force large enterprises to pay {their taxes} amounts to a massive subsidy to those powerful or resourceful enough to negotiate amnesties and settlements.*[259]

The continued existence of barter and other non-cash transactions today indicates that a significant element of negotiation still exists in government-enterprise relationships via the tax system and that the "unique economic environment" identified by the DOC is very much in evidence today:

> *After all these years of transition and tax reform, Russia's tax system still retains an important element of negotiation. This is most apparent in how settlements are reached on the payment of arrears. The practice of tax offsets, or mutual cancellation of tax arrears by taxpayers and budgetary arrears by the government*

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for barter for taxes...." *Global Steel Trade* at 50. Exh. 1; *Without a Map* at 97-98. Exh. 31; "Decentralization, Tax Evasion, and the Underground Economy: a Model with Evidence from Russia," Daniel Treisman (Jan. 2000) at summary ("*Treisman*"). Exh. 35; "Financial Crisis; Taxation System Reform Requirements," V.S. Panfilov, Studies on Russian Economic Development (Vol. 10, No. 2, 1999) at 124 ("*Panfilov*"). Exh. 36; and *Determinants of Barter in Russia: an Empirical Analysis,* Simon Commander, Irina Dolinskaya, Christian Mumssen, IMF Working Paper WP/00/55 (Oct. 2000) at 17. Exh. 37.

255 *Without a Map* at 128, 161. Exh. 31; *World Development Report 2002: Building Institutions for Markets*, World Bank (2001) at 114. Exh. 38; *Panfilov* at 124. Exh. 36.

256 *Without a Map* at 119. Exh. 31. This is further explored in *Treisman* at 2-3. Exh. 35.

257 "From Predation to Prosperity: Breaking Up Enterprise Network Socialism in Russia," Micheal S. Bernstam, Alvin Rabushka, Hoover Institution (forthcoming) (2000) at Chapter 1, 3-5, available at <http://www.russiaeconomy.org/predation.html>. Exh. 39.

258 "Taxing Times for Russia's Steel Mills," *Metal Bulletin* (Aug. 1, 1996). Exh. 40.

259 *Global Steel Trade* at 54. Exh. 1.

. . . *also continues to allow federal and regional authorities to settle and protect particular groups of taxpayers.*[260]

Suppliers and taxes were routinely not paid or paid late. . . . Moreover, the amount of taxes a company paid was essentially negotiable. . . .The difference between what was supposed to be collected and what was actually collected in cash left a lot of room for unequal tax payments among companies.[261]

In 1999 the Russian Federation began a partial and staged reform of its tax code. While the Government of Russia may argue that these partial legal reforms constitute fundamental changes that are sufficient to qualify it for market economy status, these incomplete *de jure* "reforms" are unlikely to produce an "efficient, equitable and transparent" system of taxation. In fact, during the past decade, a succession of *de jure* Russian tax measures has proven meaningless,[262] and these past reforms have been viewed by observers inside and outside of Russia as massive failures.[263] There is no observable evidence that the more recent, partial legal reforms are fundamentally changing Russia's deeply flawed tax system.... The current reform package has been described by international tax experts and multilateral institutions as "piecemeal,"[264] leaving "'big tax policy problems" unaddressed and "the main element of tax reform" yet to be implemented.[265] Moreover, many observers believe that even if the letter of Russia's tax code were fully revised, there would still be "serious problems with tax

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260 *Vazquez and Wallace* at 2270. Exh. 30. *See also* "Tax Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union," IMF Occasional Paper 182 on Issues in Transition, 1999 at 10. Exh. 32: "tax administration continues to be a highly politicized function of government, where tax liabilities are largely negotiable instead of being determined by law"; and "Building Institutions for Markets," *World Development Report*, World Bank (2002) at 113. Exh. 38: "In practice the authority of different levels of government to levy taxes, and the rates at which revenues from shared taxes were divided, were subject to continuous renegotiation, with the outcome reflecting shifting balances of political power."

261 *Global Steel Trade* at 52-54. Exh. 1.

262 While reformers attempted to revise the Russian tax code throughout the 1990s, specifically in 1991-1992 and 1996-1997, "On each occasion, the important changes were either blocked at the enactment stage or not implemented." *Without a Map* at 174, 141-42. Exh. 31. In 1991, when the first post-Soviet tax code, the Basic Principles of Taxation Law, was introduced, the bill was actually passed by the legislature and enacted into law, but key principles of it were never implemented for political reasons. Thus, Russia set an important precedent in 1991 specifically in the area of taxation, by which it has passed and enacted legislation, but simply not observed it. Similarly, a draft overhaul of the tax code was prepared in 1996-1997 -- an ongoing effort that began in 1994 -- but was gutted in the face of political opposition after many iterations, evidence of just how politicized tax reform is in Russia. The OECD observed in 2001 that Russian policymakers failures at tax reform are due to excessive politicization of the reform effort: "The experts drafted a new tax code based on such [healthy] pinciples as early as 1993, but this and subsequent reform initiatives have for many years been mired in political controversy, both federal and regional level, often becoming hostage to other political bargains." *Investment Environment in the Russian Federation* at 121-122. Exh. 5.

263 "No efforts made by the federal government between 1992 and 1998 managed to reverse the decline in tax revenues, to halt the apparent growth of the underground economy, or to stimulate rapid economic growth." *Without a Map* at 174. Exh. 31.

264 *Vazquez and Wallace* at 2273. Exh. 30.

265 "Doing Business in Russia: Taxation of Business," *Arthur Andersen* (Feb. 28, 2001) at 8. Exh. 41.

administration and evasion, corruption, arrears, tax offsets, and complementary legislation and institutions that will compromise the effectiveness of comprehensive tax reform."[266]

E. Russia is not an actual or imminent member in multilateral economic organizations such as the WTO, the OECD and the EU.

Summary of comments. Russia is unlikely to become a member, or assume the obligations and commitment of, multilateral organizations like the WTO, the OECD, and the European Union. Criticism of Russia's economic system by all three organizations underscores the extent to which Russia fails to meet their minimum standards for membership or closer affiliation.

Discussion. The Department has considered a subject country's actual or imminent membership in certain multilateral and regional institutions – with the concurrent assumption of obligations and commitments implied by such membership – as a positive indicator that the countries in question had successfully made the transition to a market economy. Russia, however, is neither an actual nor an imminent member of any of the three organizations previously cited by the Department in its affirmative decisions. Moreover, Russia's current ambivalent relationship with all of these institutions serves to underscore the extent to which its own economic system remains at variance with the obligations and commitments these multilateral/regional organizations embody and expect of their members.

1. *The World Trade Organization (WTO).*

In finding that the Czech Republic, Slovakia, and Latvia had become market economies, the Department noted with approval that all three were members of the World Trade Organization and had "assumed all obligations and commitments that such membership requires."[267] Russia, however, is not only not a member of the WTO but is bogged down in protracted negotiations with WTO members over the terms of its eventual accession. The stalemate which has become evident in these negotiations reflects above all, Russian reluctance to assume a number of the "obligations and commitments" of WTO membership, which are seen as threatening the survival of key industrial and services sectors.[268]

Russia first applied to join the General Agreement on Tariffs and Trade (GATT) in 1993, and it sought membership in the WTO when that body was formed in 1995. While the Yeltsin regime allowed Russia's WTO membership bid to languish, President Putin has pursued WTO/GATT accession aggressively, and by the end of 2000, Russia was holding bilateral talks on accession with 40 WTO countries. Russia's stance in these talks, however, has done little to advance its prospects for accession. Herman Gref, Russia's Economic and Trade Development Minister, who heads Russia's WTO accession effort, has "muddied the waters somewhat by declaring that Russia first wants to join the WTO, and then think about such technical details as

266 *Vazquez and Wallace* at 2273. Exh. 30.

267 *Czech NME Review* at 15; *Slovakia NME Review* at 14; *Latvia NME Review* at 19.

268 "Gates of World Trade: Which Side is the Lock?" *Moscow Rossiyskaya Gazeta* (Oct. 16, 2001). Dmitriy Sichinava, "Carelessness is Punishable... Joining the World Trade Organization Will Affect the Prosperity of Important Branches of the Russian Economy," *Moscow Rossiyskaya Gazeta* (Oct. 10, 2001) U.V. Prushinskiy, "Halt the Reforms of Death! Let it Be the Rule for All," *Sovetskaya Rossiya* (Aug. 16, 2001).

the liberalization of tariffs."[269] The U.S.-Russia Business Council observed recently that "cynics may call this asking for the privileges of membership without assuming the obligations."[270]

Russian intransigence has diminished expectations which existed as recently as early 2001 that accession may be imminent. In July 2001, after "the negotiation process had gained momentum," Russia's trading partners rejected its accession proposal and "the preparations of a protocol on Russia's accession to the WTO was postponed for an indefinite period." The *Economist* commented:

> *Russia's recent row with the World Trade Organization . . . highlights the problem. The Russians have become increasingly huffy about the WTO's attempts to make their laws and procedures fit international norms. This week talk about membership for Russia fizzled out, with the Russians complaining that the WTO had been nitpicking.*[271]

Russia's specific positions on issues relating to WTO accession raise questions about the extent to which it is prepared to assume "all obligations and commitments of membership." The President of Russia's Chamber of Commerce and Industry argues that the optimal way for Russia to enter the WTO is with "protection via tariffs and quotas of those sectors that have a chance of survival in conditions of the global economy until they become competitive".[272] As of September 2000, Russian tariffs averaged some 15-16 percent, or roughly twice the WTO norm. When the negotiations over Russian accession collapsed, over 2,000 tariff items remained in dispute.[273] Audrey Kushnirenko, the head of the Russian delegation to WTO commodity negotiations, recently made comments which suggest little inclination to make concessions which would significantly reduce the number of disrupted items:

> *We will not make customs duties lower than they were prior to WTO membership on any commodity position. Reduction is possible already after membership, but*

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269 *Russian Economic Survey*. Exh. 27.

270 *Id.* Exh. 27.

271 "Theory and Practice," *Economist (*July 5, 2001). Russia's attitude has been to blame WTO members for the derailing of its bid for early WTO membership. Prime Minister Mikhail Kusyanov complained the 2001 European Economic Forum in Salzburg that Russia faced "completely unprecedented demands as conditions for joining {the WTO}," from a Russian perspective a "cry from the heart" which reportedly "did not meet with great resonance among the world trade sharks." Similarly, President Putin has protested that Western governments are setting unfair terms for Russia's WTO accession, commenting sarcastically that "If it is the Western policy to raise insurmountable obstacles for Russia, it has been a success." "Russia is Disliked Because of its 'Amber' Basket -- Our Country's Prospects for Joining the WTO Remain Hazy," *Moscow Nezavisimaya Gazeta* in Russian (Sept. 19, 2001) translated in FBIS (Sept. 20, 2001). Exh. 42; "West Sets Unfair Terms for Russian WTO Entry -- President Putin," *Moscow Interfax* (Oct. 2, 2001).

272 Denis Prokopenko, "The WTO as an Instrument of the Infiltration of Competitors Onto the Country's Market," *Moscow Nezavisimaya Gazeta* (Aug. 4, 2001).

273 Konstantin Kosachev, Chairman, State Duma International Affairs Committee, "Russia and the WTO: Three Keys to Success," *Moscow Nezavisimaya Gazeta* (Sept. 13, 2001).

only in those directions where this would be advantageous to the economy of Russia.[274]

2. *The Organization for Economic Cooperation and Development.*

In finding that the Czech Republic had successfully made the transition to a market economy, the Department noted with approval that the Czech Republic had joined the OECD in 1995, "which required demonstrated commitment to an open market economy, democratic pluralism, and human rights." OECD membership "also required that the Czech Republic undertake to ensure sustained economic growth and external and internal stability, to reduce obstacles to trade in goods and services, and to liberalize capital flows."[275] Similarly, in the Department's determination designating Slovakia as a market economy, the Department noted that the country "may be ready for {OECD} membership by the end of 1999."[276]

By contrast, Russia is not an OECD member and is unlikely to become a member in the foreseeable future. Since 1992 the OECD has undertaken a "Programme of Co-operation with Russia" pursuant to which Russia is given observer status in formal OECD bodies, and the OECD sponsors or cosponsors a variety of projects designed to promote Russia's transition to a market economy.[277] The issues addressed through such projects, however, simply serve to underscore the fact that Russia not only has not made the transition to market economy but in fact, has a long way to go.[278] For example, in 2001, an OECD survey of the investment environment in Russia found that many of the rudiments of a market economy are not present:

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274 Galina Buzina, "Why Russia Must Hurry to WTO," *Strana.ru National Information Service* (Oct. 19, 2001). In agriculture, negotiations "are proceeding in a most difficult manner, with a major issue arising out of Russia's desire to maintain state support for this sector." Kushnirenko concedes that in this sector, with respect to meat, dairy products, and grains, "the degree of non-correspondence of positions {Russia's and the Western countries'} is very high." With respect to civil aircraft, Kushnirenko says, "we will not agree to any concessions in aircraft technology under any conditions. However, on individual details, as for example cabin upholstery, we may agree to reduction of duties, since this would only increase the competitiveness of our airplanes." Kushnirenko heads Russia's Department for Tariff Policy and Protection of the Domestic Market.

275 *Czech Republic NME Review* at 15.

276 *Slovakia NME Review* at 14.

277 The OECD's Center for Cooperation with Nonmembers (CCNM) has designed and administered a "Country Programme" for Russia which absorbs about a quarter of the CCNM budget. The project "provides Russian policymakers with a forum for objective and focused discussions with peers in OECD countries who have faced similar challenges.

278 For example, the OECD's 2000 survey of the Russian Federation noted the "particularly alarming trend" of demonetization of economic transactions and budgetary operations in Russia, and the proliferation of barter, offsets, and other money surrogates: "Surrogates have arguably impeded efficiency, restructuring, corporate governance, and the implementation of tax and other regulations. Neither state budgets nor firms have typically possessed enough cash to make basic wage, pension and other payments. The system of multiple prices also defies the basic logic of a market economy, as payments in kind are given a premium, as opposed to a discount, over cash payments. While some factors since the economic crisis have reduced the extent of demonetisation to some degree, the problem and its basic underlying causes remain." (emphasis added.) *OECD Economic Surveys: Russian Federation,* OECD (2000) at 19.

Much has been said... both in general and specific terms regarding the need to deal with crime, corruption, lack of security of property rights and of the endorsement of contracts and judgements in dispute resolution so as to improve the business climate for foreign and domestic investors. We have emphasized that rules-based, streamlined licensing and authorization procedures at federal, regional and local levels need to be imposed, to remove excessive administrative hurdles and arbitrary rule. Transparent guidelines and sizeable sanctions for officials who violate this rules-based system must be put in place.... Urgent attention should be paid to designing and implementing coherent policies for further development of financial markets.... [279]

3. *European Union.*

In determining that the Czech Republic had made the transition to a market economy, the Department noted with approval that the country was "on the fast track for EU membership, having so far satisfied almost all political and economic requirements for entry into the union."[280] Similarly, the Department found that Slovakia "appeared to be" on the fast track to EU membership when it found that country to be a market economy.[281] The Department observed with respect to Latvia that the country's "ongoing efforts to secure membership in the EU , particularly those designed to conform Latvian social and legal institutions with EU norms, will necessarily deepen and strengthen the overall reform results."[282]

Russia, on the other hand, is not on a "fast track" for EU membership, or, for that matter, on any track at all. European and Russian leaders sometimes speak favorably of eventual Russian membership, but there is at present not even the beginnings of an initiative which might bring such membership about.[283] In May 2001, Russia's Minister of Foreign Affairs, Igor Ivanov, said "I cannot imagine Russia's membership in the European Union at present."[284] In July 2001 Russian Prime Minister Mikhail Kasyanov said that Russia would not apply for membership in the EU.[285] Jacques Chirac, President of France – which wields powerful influence within the EU – said in July 2001 that Russia should remain outside the EU:

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279 *Investment Environment in the Russian Federation* at 36. Exh. 5.

280 *Czech Republic NME Review* at 15.

281 *Slovakia NME Review* at 44.

282 *Latvia NME Review* at 19.

283 Louis Michel, Chairman of the EU Council, said in August 2001 that Russia might become an EU member in "a not too distant future." "Russia Sometime EU Member? Alpach Debate on Power Structures," *Die Presse* (Aug. 28, 2001). Italian Foreign Minister Renato Ruggiero said in Sept. 2001 that Russia should be admitted to the EU "one day, in accordance with a timetable and modalities that need to be agreed upon." "The Government Must Be United – Europe is Our Pole Star," *La Repubblica* (Sept. 11, 2001).

284 "Russian Foreign Minister Says EU Membership Not on Current Agenda," *Moscow ITAR-TASS* in English (May 10, 2001) *reported in* FBIS (May 10, 2001). Exh. 50. Even advocates of Russian EU membership see it occurring in the distant future – an event that is decades or more away. Sergei Karaganov of Moscow's European Institute said in July 2001 that "just like himself, numerous Russians believe that it must be Russia's goal to become a member of the EU in one generation." *Radio Österriech* (July 2, 2001).

285 "Russia Not Seeking EU Membership – Premier," *Moscow ITAR-TASS* in English (July 3, 2001) *reported in* FBIS (July 3, 2001). Exh. 43.

Relations between the European Union and Russia most became more and more integrated, but at the same time I don't think anyone can imagine that Russia is about to join the European Union. I don't think this is where its goal and its destiny lies.[286]

F. The Russian economy is poorly integrated with the multilateral trading system, reflecting import barriers, chaotic marketing of exports, and much of Russia's foreign trade and customs administration is controlled by organized crime.

Summary of comments. Russia's economy is not integrated with the world trading system and in fact has exercised severely destabilizing effects on that system. The Russian domestic market is protected by a broad array of import restrictions, while disorderly Russian exports have had chaotic effects in world markets since 1991. Much of Russia's foreign trade, as well as a considerable part of the administration of the Russian customs service, is controlled or influenced by organized criminal groups.

Discussion. The Department regards the degree of integration of a subject country into the multilateral trading system as a factor to be considered in determining whether the country has made the transition to market economy status. Thus, one factor cited by the Department in summarizing its determination that Latvia had made the transition to a market economy was its finding that

Full trade liberalization has reintegrated Latvia into the multilateral trading system, linking prices, producers and consumers in Latvia to world markets.[287]

Similarly, the Department stated in its affirmative determination of the Czech Republic's transition to market economy status that the country had liberalized trade and "successfully integrated itself into the global community." The Department indicated in its Czech decision that while integration into the world economy was not itself dispositive of a successful transition to a market-based economy, it was nevertheless a significant step.[288] In its affirmative determination with respect to Slovakia's transition to a market economy, the Department commented:

As a participant in the Uruguay Round of multilateral trade negotiations, Slovakia significantly reduced its trade-weighted average tariff rate and bound 100 percent of its industrial tariff lines, resulting in a post-Uruguay Round average tariff rate of just under four percent. The Uruguay Round helped to consolidate and institutionalize the broad range of trade reforms Slovakia had undertaken to date.[289]

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286 "French President Advises Russia Against Seeking EU Membership," *Moscow Ekho Moskvy Radio* in Russian (July 3, 2001) *translated in* FBIS (July 3, 2001). Exh. 44.

287 *Latvia NME Review* at 1.

288 *Czech Republic NME Review* at 16.

289 *Slovakia NME Review* at 14.

By contrast, Russia is not only not integrated into the multilateral system, but has produced and is producing severely disruptive effects within that system. The Russian market remains protected by numerous tariff and nontariff barriers, many of which are arguably inconsistent with WTO and other multilateral norms, and all of which lessen the degree of integration of Russia with the world trading system. The extent to which Russia's foreign trade enterprises and the Russian customs and trade bureaucracy are engaged in criminal activity underscores the fact that Russia is not yet – and may not be for some time – "integrated" into the multilateral system.

1. ***Formal government import restrictions.*** Exporters to Russia confront a broad array of formal government-imposed trade restrictions, from tariffs and inconsistent agency standards to government procurement barriers.

Between 1995 and 2000 Russian **tariffs** had a trade-weighted average of 11.5 to 15 percent. On top of the tariff, a 20 percent value-added tax has been applied to almost all imports (applied to the price of the import plus the tariff).[290] The combination of tariffs, VAT, and sector-specific excise taxes constitute significant barriers for major product categories. USTR noted in 2001 that:

> *Russian import tariffs that continue to stand out as particular hindrances to U.S. exports to Russia include those on autos, where combined tariffs and engine displacement-weighted excise duties can raise import prices of larger U.S.-made passenger cars and sport utility vehicles by over 70 percent. The Russian Government continues to have prohibitively high duties on imported aircraft (20 percent). Tariff waivers for purchase of foreign aircraft have been contingent on those airlines' purchases of Russian-made aircraft. In addition, Russian tariffs for U.S. wood product exports are at a level of 20 percent, compared with the preferential rate of 5 percent for tropical hardwood logs, lumber and veneer.*[291]

The EU comments that Russian "duty levels have been used to fund the federal budget (hence the high duties on goods with the highest levels) and to protect domestic industries, although Russia denies the latter."[292] Russian tariffs are not bound, reflecting the fact that Russia has not assumed WTO obligations.[293]

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290 Under a revision of the tariff regime which went into effect on January 1, 2001, tariff categories were consolidated into major product groups. The Russian government indicated this charge would reduce average tariff rates to 10.7 percent, but as USTR notes, "in some cases tariff unification will cases rates for individual items to rise." *2001 National Trade Estimate Report on Foreign Trade Barriers*, U.S. Trade Representative (2001) at 379 ("*Foreign Trade Barriers*").

291 *Foreign Trade Barriers* at 379.

292 *Russia: General Features of Trade Policy* (EU Sectoral and Trade Barriers Database). http://mkaccdb.eu.int/mkcdb/chksel.pl (visited Oct. 9, 2001) at 4 ("*Russia: General Features of Trade Policy*").

293 The European Union observed in 2001 that "Russian tariffs have changed several times since 1994; there is a trend to increase and maintain high level tariffs in the textile sector especially for carpets and garments." *Id.* at 5.

In its 2001 Foreign Trade Barriers Report, USTR cited numerous problems associated with **product standards, testing, labeling and certification** which constituted significant trade barriers:

> *U.S. companies report that Russian standards and procedures for certifying imported products and equipment are non-transparent, expensive, time-consuming, and beset by redundancies.*[294]

Similarly, the EU complains that "standards, testing and conformity assessment procedures continue to represent a significant obstacle to market access in Russia, and European exporters are faced with a variety of problems."[295]

For a number of years Russia has been working to implement product standards and procedures for certification that are consistent with international norms, and USTR reported in 2001 that about 30 percent of 22,000 Russian standards had been brought into alignment with these norms. However, the European Union reports that "progress in this area remains patchy and insufficient in spite of some encouraging signs."[296] USTR commented in 2001: "the current Russian product certification regime makes it difficult to get products into the Russian market and creates barriers to Russian exports as well."[297]

Public procurement accounts for roughly 15 percent of Russia's total GDP. The European Union comments that "access to {the Russian} market for foreign supplies, suppliers and service provides is, at best, erratic."[298] The EU notes that Russia is planning to establish a public procurement regime largely based on the UNCITRAL Model Procurement Law. However, at present,

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294 *Foreign Trade Barriers* at 380. USTR notes that "certain improvements can be noted in the process of standards setting and the repeal of onerous labeling requirements, which were actually repealed prior to the implementation. Russian regulatory bodies are reluctant to accept foreign testing centers' data or certificates. U.S. firms active in Russia have complained of limited opportunity to comment on proposed changes in standards or certification requirements before the changes are implemented. Occasional jurisdictional overlap and disputes between different regulatory bodies compound certification problems." *Id.*

295 *Russia: General Features of Trade Policy* at 9.

296 *Id.* at 5. The EU complains that several categories of instruments are called "standards" in addition to those called "state standards," and that "their legal status is difficult to understand." Conformity assessment procedures are "unduly burdensome and expensive," and the EU believes that testing and certification procedures are "sometimes imposed for essentially protectionist reasons." *Id.*

297 *Foreign Trade Barriers* at 380. "Manufacturers of telecommunications equipment, construction materials and equipment, and oil and gas equipment continue to report serious difficulties in obtaining product approvals. Certification is particularly costly and prolonged for telecommunications equipment, which is tested for compliance with standards established by both the State Standards Committee (Gosstandart) and the Ministry of Communications and Information. Interpretation of these standards can vary from region to region. The certification process can take as long as 12-18 months. After going through the lengthy certification process, product certification lasts for only three years, rather than for the life of the product. Self-certification in this area is currently not possible." *Id.*

298 *EU, Russia: General Features of Trade Policy* at 14.

public procurement, to the extent that it is regulated at all, is covered by a 1994 Law (60-F2) and a 1997 Interim Decree (305). The 1994 Law does not distinguish between public procurement and purchases for resale to the general population; both fall under the category of 'purchases for State needs'. The law effectively excludes the participation of foreign suppliers and service providers from procurement. The 1997 Decree supplements the Law (and does not replace it). It sets out more detailed rules on procurement only and aims to establish an open procurement procedure based on tendering. However, the Decree does not confer any additional access rights to the procurement markets....It is understood that, in due course, the 1997 Decree will be replaced by a Special Federal Law on Procurement (based on the UNCITRAL Model Law) which is currently going through the legislative process. Whilst the 1994 Law will remain on the Statute books, it will be amended so that it only covers purchases for resale to the general public.[299]

The Office of the U.S. Trade Representative also cites significant barriers in Russia's public procurement policies in its 2001 report on foreign trade barriers.[300]

2. *Disruption of foreign markets.* Russian commercial activities in foreign markets during the past decade can hardly be characterized as displaying smooth integration with the multilateral system. In fact, Russian exports -- particularly of metal products -- have been repeatedly cited for dumping in dozens of countries, and surges of Russian aluminum and steel exports, in particular, have caused tremendous economic harm.[301] The Department of Commerce observed in 2000 with respect to a massive export surge in 1998 that "huge volumes of steel were exported at very low prices," and concluded that the economic devastation which followed was attributable to the absence of normal commercial considerations.[302]

The export of goods on a barter basis (countertrade) was a common trade practice of the Soviet Union and its former satellites, and the practice has continued in Russia's foreign trade. In the mid-1990s, according to one source, barter and mutual offset transactions accounted for 40

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299 *Id.* at 14.

300 "The Russian Government has a strong political bias toward supporting domestic industries. An example of such bias occurred in 1997 when government agencies were directed to use only domestic automobiles (a program, which ran into problems and is currently not strictly enforced). Additionally, U.S. pharmaceuticals manufacturers have reported lack of transparency and discriminatory treatment of foreign companies in state tenders for pharmaceuticals purchases." *Foreign Trade Barriers* at 381.

301 In aluminum, "the chaotic, distinctly uncivilized entry of Russian enterprises onto the market in 1992-93 literally collapsed prices on the London Metals Exchange." "The New Repartition of Russian Metallurgy," *Segodnya* (Oct. 6, 1995). According to *Izvestiya* Russian metal products are subject to over 50 antidumping orders in various countries around the world. "Honored Second Place," *Izvestiya* (July 12, 2001).

302 "The lack of normal business considerations at the investment, production and selling stages in the Russian steel industry led to volatility in the global steel market and damage to the steel industry and steel workers in other countries, including the United States. While the Russian steel industry has the potential to be competitive in world markets in the long-term, it must address the underlying market-distorting practices to avoid the kind of trade frictions it has encountered in the past." *Global Steel Trade* at 64 (emphasis added). Exh. 1.

percent of Russia's export sales volume.[303] The export of commodities on a barter basis can severely disrupt world market for those products. Western firms generally acquire commodities in barter arrangements at a lower cost than would be the case in money transactions.[304] The extensive use of barter and mutual offsets in Russia's internal commercial transactions also has disruptive effects in export markets. Barter masks the true costs of goods and services and facilitates low prices exports on a basis which, in a market economy, would be uneconomic.[305]

3. *Organized criminal activities in the conduct and administration of Russian foreign trade.* Numerous sources in Russia report that the Russian Customs Services are under the influence of organized criminal groups, and that major elements within the Customs Service are direct participants in a broad array of criminal activities. One Russian observer complained recently that the Customs Service is "actually nurturing crime with its own resources."[306] Alexandr Murzin, the former chief of the Tax Law Enforcement Office of the Russian Federation Procuracy General, published a book in 2001 which concluded that:

> *The foreign trade businesses in the Moscow region today are completely criminalized. They are owned by various crime gangs, whose members include... members of the customs service... We can safely say that all of the lawlessness in the customs sphere was contrived and consciously supported by a certain segment of the so-called elite of our state and is intended to enrich it with no possibility of punishment.*[307]

A report in *Novyye Izvestiya* in October 2001 commented that:

> *the sphere of foreign trade operations in our state is essentially a sphere of criminal business... the sphere is managed by various crime gangs, made up of individuals directly engaged in commerce and personnel of the customs service, MVD {Ministry of Internal Affairs}, FSB {Federal Security Service}, and other law enforcement agencies, who render various services for the gangs within the confines of their professional authority. Their colossal 'illegal cash flow' provides unlimited opportunities to bribe officials of the customs service and*

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303 "In the Fight for Sales Market Metallurgists Seek Ways of Reducing Export Prices," *Nezavisimaya Gazeta* (April 1, 1997).

304 "Barter prices for rolled metal, as a rule, are lower than they are with case settlements," *Id.* "'Wild' exporters, who have in their hands barter metal as a settlement for services, also do considerable damage. As a rule they export it at reduced prices." "Strengthening of the Ruble Facilities Metallurgists Export Income," *Finansovyye Izvestiya* (Aug. 3, 1995).

305 A Russian commission summarized the problem as follows: "An economy is emerging where prices are charged which no one pays in cash; where no one pays anything on time; where huge mutual debts are created that also can't be paid off in reasonable periods of time; where wages are declared and not paid; and so on... {This creates} illusory, or "virtual" earnings, which in turn lead to unpaid, or "virtual" fiscal obligations, {with business conducted at} nonmarket, or "virtual" prices." Report of Interdepartmental Balance Commission, *Crisis of Payments* (1998), cited in *Global Steel Trade* at 50.

306 Sergey Sokolov, "Completely Transparent Borders for Weapons and Contraband," *Moscow Novyye Izvestiya* in Russian (Oct. 25, 2001) *translated in* FBIS (Oct. 25, 2001). Exh. 45.

307 *Id.* Exh. 45.

other law enforcement agencies and to criminalize that whole sphere of operations and the related law enforcement system. As a result, about half of the customs fees due are never paid.[308]

Organized criminal activity in Russia's foreign trade typically involves "customs personnel on various levels" as well as shell companies and the personnel of warehouses and storage facilities handling goods moving in foreign trade.[309] In August 2001, Russian Interior Minister Boris Gryzlov complained that:

the Archangel, Kaliningrad, Murmansk and St. Petersburg sea trading ports were 80 percent controlled by organized criminal groups, as were many light, food, and processing industrial enterprises in St. Petersburg itself and timber exports and tobacco and alcohol imports in Northwestern Russia.[310]

In August 2001 a government daily newspaper reported with respect to Novorossiysk, Russia's largest port, that:

{A} well-organized criminal system has developed in the {Novorossiysk} port complex, and law-enforcement authorities have turned out to be helpless against it.[311]

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308 *Id.* Exh. 45. In January 2001 Russian-General Vladimir Ustinov severely criticized the Transport Prosecutor's office for lax supervision of the Customs agencies, noting that only 4 percent of the cases against crime by Customs personnel went to court. "Russian Prosecutor Urges Better Supervision of Law -- Enforcement Bodies," *RIA* (Jan. 12, 2001).

309 Temporary storage facilities are set up "with the support of officials of the State Customs Committee and the Central Customs Administration." Shell companies set up by the owners of the storage facilities operate for 2-3 months as consignors of exported goods and consignees of imports, and handle all contacts with the carrier, customs officials abroad, and Russian customs. When goods reach the storage facilities, their personnel alter or replace the shipping documents in order to qualify for lower customs duties. These documents are submitted to OTOTK, the Customs Clearance and Inspection Division, whose personnel "generally collect bribes openly from the warehouse managers" and conceal the "criminal activity of the temporary facility." The OTOTK officials then clear the goods without inspecting them or verifying that they match the shipping documents (the latter are frequently destroyed). The temporary storage facilities generally pay the OTOTK \$50 to \$100 per false declaration. *Id.*

310 "Many Russian Businesses Under Criminal Control," *Moscow ITAR-TASS* in English (Aug. 8, 2001) *reported in* FBIS (Aug. 8, 2001). Exh. 46.

311 "And the Wharves Sail Away Like Ships," *Moscow Rossiyskaya Gazeta* in Russian (Aug. 24, 2001) *translated in* FBIS (Aug. 24, 2001). Exh. 47. In 1998 the Administrative head of the Krasnodar Kray issued a decree entitled "On the Loss of Economic Security at the Seaports of the Azov-Black Sea Seaboard," and initiated nearly 200 criminal proceedings and establishing a special "Internal Affairs Administration" (UVD) responsible for reestablishing order in the Black Sea ports. However, many of these cases were dismissed and federal investigators ran into a wall of resistance from local officials and even the staff of the newly-formed UVD. Mikhail Fetisov, Deputy Plenipotentiary of the Southern Federal District, commented that, "I think that the new enforcement agencies ran up against a well-organized criminal system in the port complex.... We also ran up against the open unwillingness of the staff members of the UVD for Transport to get the truth... The legal confusion and impunity for crimes committed prevents the solution of many economic problems and even questions of navigation safety." "Everything is in Full Swing in the Port, But Nothing is Visible," *Moscow Rossiyskaya Gazeta* in Russian (July 17, 2001) *translated in* FBIS (July 17, 2001). Exh. 48.

Similar problems are reported in the Russian Far Eastern maritime area, which has been characterized by wholesale corruption and bloody struggles between organized gangs over control of shipping and trade in oil, minerals, fish, and other products.[312] In the Baltic, a powerful St. Petersburg-based criminal group, the Tambovers, has achieved control over many export channels in the Baltic Region.[313] "Vast smuggling" has been rampant on the Russia-China border, with smuggling generating enough income to finance the creation of entire new towns along the porous border region.[314] In Russia's Kaliningrad Oblast, a European enclave geographically cut off from Russia proper, Vice Governor Anatoliy Khlopetskiy estimated in October 2001 that more than half the Oblast economy was in the illegal sector."[315]

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312 Widespread involvement of Customs officials and other regulatory authorities in these activities has been reported. "The corruption of customs officers of Sakhalin {Island} is quite high and causing... concern." In one incident, federal authorities "exposed a group of {customs} inspectors extorting bribes from businessmen, sailors and fishermen." In another, a customs officer was "caught totally red-handed, five marked banknotes in 10,000 yen having been found on a senior inspector of the Korsakovskiy Post during a search." Yana Aminyeva, Grigoriy Maslov, and Viktoriya Chernysheva, *Organized Crime of the Far East: Maritime Region, Khabarovsk Kray, Yakutia,* (Valadivostok Center for the Study of Organized Crime, *Moscow Compromat.Ru WWW)* (Feb. 27, 2001).

313 The Tambovers have been challenged at intervals by rival gangs and – intermittently – by federal authorities, but despite the loss of many members in gun battles and contract killings, the gang remains powerful. A Russian source, commenting in August 2001 on the Tambovers' abiding economic power, stated, "The St. Petersburg economy has been publicly characterized as a conglomerate of industrial, energy and trade enterprises controlled by organized crime. The crime bosses of the 'Tambov Crime Society' have been named as the masters of the city.... The Tambovites power is based on connections with the city authorities and above all with certain enforcement structures." "The Beginning of the Great Raid," *Moscow Freelance Bureau WWW* (Aug. 17, 2001). In 2001 Russian Interior Minister Boris Gryzlov complained that the Tambovers controlled "up to 100 percent of industrial enterprises" in St. Petersburg, adding that it is impossible "to put up with this situation." "Many Russian Businesses Under Criminal Control," *Moscow ITAR-TASS* (Aug. 8, 2001).

314 Petr Goncharov, "Official Says Capital Drained from Russia to China," *RIA* (June 10, 1999).

315 "Contraband Economy," *Moscow Vedomosti* (Oct. 29, 2001). A local Russian business association executive commented in October 2001 that "the border trade and the related semi-legal businesses constitute the whole economy of the six border cities in the Kaliningrad Oblast. They have no tax base whatsoever." Russian observers blame, among other factors, the former Governor of the Oblast, Leonid Gorbenko, who was the target of numerous allegations of dubious financial dealing: "It is criminal structures that benefited most from former Governor Gorbenko's policy. The tobacco, vodka, and car mafias have become a real economic and political force. Like, cancer, they have spread into state and law-enforcement structures. They shifted huge money – enough for restoring old German villas, buying expensive cars, and giving bribes to necessary people. Bursts from assault rifles and bomb explosions rocked the streets. The law-enforcement agents indifferently watched this...." "An Examination of the Economic Structure of Kaliningrad Oblast," *Moscow Vedomosti* in Russian (Oct. 29, 2001) *translated in* FBIS (Oct. 29, 2001). Exh. 49; "The Hamburg Reckoning," *Moskovskidy Komsomolets* (June 26, 2001).

G. Land reform has thus far proven a failure, and less than 2 percent of Russia's land is eligible for privatization.

Discussion. The Department commented positively on land reform efforts in its recent affirmative determinations that Latvia, Slovakia and the Czech Republic had become market economies. In Russia, by contrast, after a decade of failed reforms, one of the most fundamental elements of a market economy – the right to buy and sell land – is still largely absent. Russian economic Development Minister German Gref, acknowledges that "the country's failure to enact land reform has been a major obstacle to both domestic and foreign investment."[316] This view is echoed by international experts including the OECD, IMF, EBRD, World Bank, and others.

While it is true that the Duma finally passed a Land Code in September 2001, after ten years of acrimonious debate, it covers only 2 percent of Russia's land. Moreover,

> *Most of this 2 percent is land that can't be privatized in any case -- streets, roads, squares, public facilities -- or there's already something built there, in which case the owner of the building is first in line to buy the land. So you can't exactly call it the market . . . market prices will only concern the tiny percentage of land that is currently free.*[317]

1. A legacy of failed reforms. From the outset, Russia's economic reformers acknowledged that land reform was a fundamental element in the transition to a market economy. Between 1990 and 1997, a series of presidential decrees and government resolutions denationalized the majority of Russia's urban and rural land.[318] However, the issue of private ownership of land is:

> *a classic Russian muddle: it exists in theory, not in practice. The Constitution allows it . . . But a proper land code, explaining everything from mortgage rights to rules on how land can be used, has never reached the statute book.*[319]

The absence of such legislation led to the emergence of regional improvisation on the one hand, and rampant corruption and criminalization of the land market on the other.[320] The "glaring

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316 Sophie Lamborschini: "Russia: Government Takes Uncertain Road to Land Privatization," *Radio Free Europe,* (Feb. 9, 2001).

317 "Land Ownership Is the Last Big Soviet Hurdle," *The Russia Journal* (Oct. 19, 2001).

318 The Russian Constitution declared that land could be private property. "But beyond a constitutional pledge to ensure the privatization of land, there are few laws on the books to implement the provision. That has left farmers in a legal limbo and politicians in ideological warfare." Sophie Lamborschini: "Russia: Government Takes Uncertain Road to Land Privatization," *Radio Free Europe* (Feb. 9, 2001).

319 "Land Reform, Kind of, Maybe," *Economist* (Mar. 8, 2001).

320 For example, while land belonging to industrial enterprises was privatized in St. Petersburg, Novogrod and Tver, in Moscow, the authorities exempted the city from privatization decrees and made the city owner of all land within its boundaries. According to one study of five Russian regions, despite Federal legislation, privatization is restrained by local administrations: "For this purpose they use not only direct ban on urban land privatization in the form of local legal acts but also indirect economic measures. "Leon Aron, "Land Privatization: The End of the Beginning," *AEI Russian Outlook* (Summer 2001); Vladislav Miagkov: "Comparative Analysis of Urban Land Privatization Process in Russia 1994-2000," *International Centre*

contradictions in federal and regional land legislation," left the law "wide open to creative interpretation by local officials looking for a handout."[321] In addition, the absence of legislation forced land sales into the shadow economy, where much of the land market has operated for years.[322]

2. Urban Land Reform.

The new Land Code enacted in 2001 does allow for the sale of urban land; it legalizes the ownership of 40 million dacha plots; allows enterprises to own the land on which their businesses are occupied; and allows foreign ownership of urban land, excluding land near national borders and land deemed important to national security. Local governments can no longer refuse to sell land without Federal authority to do so, and must bring local laws into line with Federal legislation.[323] However:

> *There could be any number of brakes on the land bonanza: an entrenched bureaucracy, quarrels over setting prices or recalcitrant local administrators unwilling to give up their grip on state-owned land . . . . The Land Code on its own won't be able to completely change the situation because there is a very notorious bureaucratic tradition existing in this country and an ineffective justice system....*[324]

In Russia, initial privatization of rural land came in the form of paper certificates entitling the holder to ownership of a plot of land, without specifying an actual physical plot. The underlying land resources and production assets were left in the hands of the former collective farm or its corporate successor. Therefore, despite reallocation of land, collective and corporate farms continue to dominate Russian agriculture and "continue to be managed like traditional collectives, showing very little internal restructuring."[325] In the interests of maintaining rural employment, the "red managers" rely on support from the state to subsidize their operations and

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for Social and Economic Research "Leontief Centre" and Lincoln Institute of Land Policy Conference, (May 29-30, 2001).

321 Sophie Lamborschini, "Russia: Government Takes Uncertain Road to Land Privatization," *Radio Free Europe* (Feb. 9, 2001).

322 The Moscow State Legal Academy has reported on "the existence of an 'illegal, criminal turnover of land' and the 'enormous criminalization' of the real estate market. "Leon Aron: "Land Privatization: The End of the Beginning," *AEI Russian Outlook* (Summer 2001).

323 "President Signs Off on Sale of Land," *Moscow Times* (Oct. 29, 2001).

324 "Real-Estate Market Gears Up For Land Sales," *Russia Journal* (Oct. 19, 2001). The Land Code fails to establish the principles for clarifying what real estate belongs to the Federal Government and what belongs to the regions. For example, Moscow is willing to relinquish land under Federal buildings, such as the Duma and Supreme Court, but the Federal Government is claiming ownership of 70 percent of the city's land. In the provinces, "land ranks along with the tax system as a huge source of control and patronage for local leaders and their friends" and, as the new Land Code allows governors to interpret the code flexibly, especially on designating land use, "that sounds bad for reform." "Russia: Moscow To Seek Clarification Amendments to New Land Code," *Moscow Center TV* (Oct. 14, 2001); "Land Reform, Kind of, Maybe," *Economist* (Mar. 8, 2001).

325 Zvi Lerman, "Comparative Institutional Evolution: Rural Land Reform in the ECA Region," *World Bank* (2001).

do not face hard budget constraints. Furthermore, under real market conditions, owners of reallocated land would seek to either buy or sell their land on the market. A decade after the initiation of economic reform, the Russian government is still divided over land issue and unable to solve the crucial question of private ownership of agricultural land:

> *Mr. Putin and the prime minister, Mikhail Kasyanov, suggested that they did not wish to make a priority of what remains an emotive issue and, for the most part, an unpopular cause. Ordinary Russians, particularly in rural areas, remain wary of proposals for liberal land reform.*[326]

3. Rural Land Reform. As the Department of Commerce has noted, the implementation of land reform is an important indicator that former socialist countries have made a successful transition to a market economy. Rural land reform and the restructuring of agriculture is an essential component in this transition, especially as agriculture plays a comparatively large economic and social role in former socialist countries. According to a World Bank study:

> *Private ownership of agricultural land is the norm in market economies, and incentives associated with property rights in privately owned land are usually regarded as one of the factors conducive to efficient agriculture. Privatization of land is therefore a major institutional change envisaged by the transition agenda . . . .Transferability of land and development of land markets are as important as privatization of land in determining the impact of land policies on productivity and efficiency in transition countries.*[327]

In addition, as individual or family farms are the norm in market economies, it is essential to measure the transition countries against the benchmark of individual farming.[328] Besides, "formal claims of privatization and adoption of reform do not necessarily reflect the actual situation on the ground."[329]

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326 "Russia: Country Profile 2000," *Economist Intelligence Unit,* 2000, at 33.

327 Zvi Lerman, "Comparative Institutional Evolution: Rural Land Reform in the ECA Region," *World Bank,* 2001.

328 *Id.*

329 *Id.*

IX. Conclusion

Russia is not a market economy, and simply declaring it to be one prematurely risks rendering anti-dumping investigations against Russian industries unworkable. The purpose of the NME statute is to identify countries for which the calculation of factors such as prices, costs and subsidies is impossible due to the use of barter, non-payment of taxes, and pervasive government control over the price and availability of inputs. Because all these conditions are prevalent throughout the Russian economy, granting a change in NME status would require the Department to re-examine existing antidumping margins.[330] Such an examination would prove difficult, as a practical matter, because prices, costs and inputs are not generally determined by the market. Most Russian industries would not even pass the market oriented industry (MOI) test, which is supposed to serve as an interim category for transitioning industries. Applying "market economy" rules to NME countries will produce inequitable and economically irrational results so long as prices and enterprises remain under state control, regardless of the label bestowed on the country by the Department.

330 Currently, there are seven anti-dumping cases involving Russia before the Department of Commerce, encompassing products from the steel, uranium, magnesium, and ammonium nitrate sectors, all of which would require re-examination if Russia transitions from NME status. Ammonium Nitrate (A-821-811), Cut-To-Length Carbon Steel Plate (A-821-808), Hot-Rolled Flat-Rolled Carbon Quality Steel Products (A-821-809), Cold-Rolled Steel Flat Products (A-821-815), Pure Magnesium (A-821-813), Structural Steel Beams (A-821-814), Uranium (A-821-802).